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IN THE

Supreme Court of the United States

October Term, 1966

No. 954

CBN CORPORATION (formerly COLUMBIAN CARBON COMPANY),

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

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Respondent.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Claims in this case.

Opinion Below

The opinion of the United States Court of Claims (R. 255-264) is reported at Ct. Cls. , 364 F.2d 393 (Ct. Cl. 1966) and is reprinted in Appendix A, *infra*, pp. 1a-13a.*

Jurisdiction

The judgment of the United States Court of Claims (Appendix A, *infra*, p. 13a) was entered on July 15, 1966. Petitioner's motion for rehearing was denied on October 14, 1966 (R. 294, 295). The jurisdiction of this Court is invoked under 28 U.S.C. § 1255(1).

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* References to "R" are to the certified transcript of the record in this case.

Questions Presented

1. Where there has been no change in parties, facts or in the law as applied to those facts or similiar facts:

a) Whether a subjective alteration in approach or reasoning by the Court below in applying long-standing and unchanged legal principles to dissimilar facts can constitute such "a change in legal atmosphere or climate" as to preclude the application of the doctrine of collateral estoppel or estoppel by judgment.

b) Whether similarities in language or terms used in correctly deciding an intervening case which is factually dissimilar can constitute such "a change in legal atmosphere or climate" as to preclude the application of the doctrine of collateral estoppel.

c) Whether the subjective change in appraisement of facts previously litigated, plus a change of mind by the Court below as to the facts deemed to be determinative, can constitute such "a change in legal atmosphere or climate" as to preclude the application of the doctrine of collateral estoppel.

d) Whether the Court below may lawfully refuse to apply collateral estoppel in order to reconsider the merits and then redecide the issue by reference to questions neither litigated nor decided in the prior case.

2. Where there has been no change in parties, facts or in the law as applied to those facts or similar facts, whether the Court below may lawfully change its mind as to the factual criteria necessary to sustain a plaintiff's burden of proof but refuse to allow the plaintiff to meet that burden.

3. Whether petitioner in fact has acquired an economic interest in minerals in place entitling it to the depletion allowance under the Revenue laws.

Statutes and Regulations Involved

The statutes and regulations involved are sections 611(a) and 613(a) and (b) of the Internal Revenue Code of 1954, 26 U.S.C. Sections 611, 613, and Treasury Regulations, Section 1.611-1, 26 C.F.R. Section 1.611-1. The pertinent portions of the statutes and regulations are set forth in Appendix B, *infra*, pp. 1b-2b.

Statement of the Case

In 1935 petitioner's predecessor entered into a contract with Shamrock Oil and Gas Corporation under which petitioner agreed to purchase from Shamrock at a stated price substantial quantities of gas consisting of dry hydrocarbons for the purpose of manufacturing carbon black in Moore County, Texas. At that time, carbon black manufacture was the only use for such hydrocarbons permitted by Texas law. Under the contract the mutual obligations ran for the life of the specific gas reserves which were dedicated to petitioner. Petitioner was also given the right to cease manufacturing carbon black and to resell the gas, in which event Shamrock was to be paid a minimum of two cents per thousand cubic feet with the excess of the sales price over that amount being divided equally between petitioner and Shamrock.

The parties performed under the contract until 1951, when Shamrock indicated a desire to be free of its dedications under the 1935 contract so that it could enter into a long-term contract to sell gas to Northern Natural Gas Company at a more favorable price. Accordingly, in 1952, by agreement between the parties, the 1935 contract was specifically terminated and a new contract was executed effective January 1, 1953 under which Shamrock agreed to pay petitioner six cents for every thousand cubic feet of gas "produced and sold" to Northern Natural Gas from the reserves previously dedicated to petitioner under the 1935 contract. Payment was to continue for the life of

the reserves and would be adjusted only if the sales price to Northern Natural Gas was reduced below ten cents per thousand cubic feet.

On its Federal Income Tax return for the taxable year 1953, petitioner claimed the depletion allowance on the amounts received from Shamrock pursuant to the 1952 contract. When said depletion was disallowed on audit of the return, petitioner paid the deficiency and brought suit in the United States Court of Claims.

In its opinion and decision filed on February 14, 1964, *CBN Corp.* v. *United States;* 328 F.2d 316 (Ct. Cls. 1964) (Appendix C, infra, pp. 1c-25c), the Court of Claims (with one dissent), after reciting that it did not believe that petitioner had acquired an economic interest in the gas under the 1935 contract, held this fact to be immaterial as under the new 1952 contract petitioner had acquired an overriding royalty interest in the gas in place, thus entitling it to the depletion allowance. The judgment was entered on March 20, 1964. Certiorari was not requested by the United States. The same issue was litigated for 1954 and judgment for the taxpayer, petitioner herein, was stipulated.

On December 11, 1964, the Court of Claims decided the case of *Tidewater Oil Co.* v. *United States,* 339 F.2d 633 (Appendix D, infra, pp. 1d-15d) wherein it held, without referring to the prior *CBN* case, that the transferors of short-term oil production allowables (Elm Oil Company) did not obtain an economic interest in the transferee's (Tidewater) oil extracted pursuant to such allowables where the price for the allowables was a stated price per barrel of oil produced thereunder. The grounds for the holding were that there was no proof that the transferor's oil reserves were being depleted by Tidewater's use of the allowables and, further, that the transferor had *not* obtained a royalty interest in Tidewater's oil.

Meanwhile, the disallowed depletion allowance on amounts received by petitioner under the same 1952 con-

tract in the years 1955 and 1956 were pending under suit for refund in the Court of Claims (R. 1-106). On April 7, 1965, petitioner moved for summary judgment on the ground that the doctrine of collateral estoppel, or estoppel by judgment, entitled it to recover for those years. On June 4, 1965, defendant United States cross-moved for summary judgment on the grounds that collateral estoppel did not apply and that on the merits, petitioner did not have an economic interest under the 1952 contract.

On July 16, 1965, while the motions for summary judgment in the instant case were pending before it, the Court of Claims decided the case of *Food Machinery and Chemical Corp.* v. *United States,* 348 F.2d 921 (Appendix E, infra, pp. 1e-16e) wherein, without reference to either the prior *CBN* or *Tidewater* cases, it held that a processor and manufacturer of phosphate chemicals had acquired an economic interest in phosphate shale sufficient to afford it the depletion allowance where, pursuant to a contract, it agreed to build a processing plant and *purchase* for twenty-five years the phosphate shale which was extracted and piled on the surface by a miner in the course of mining phosphate rock. The grounds for the decision were that since the sale of the shale overburden to a processor was essential to make the mining of phosphate rock economically feasible, said processor, Food Machinery & Chemical Corp., though a stranger to title and to the lease, was essential to the mining of the phosphate rock and thus had an economic interest in the mineral in place.

In its opinion and decision entered in the instant case on July 15, 1966 (Appendix A, infra, pp. 1a-13a), the Court of Claims (with two dissents) denied petitioner's motion for summary judgment and granted defendant's motion on the grounds that:

> (1) collateral estoppel does not apply because that Court's opinion in the *Tidewater* case represented a "material alteration in approach to the

overall depletion question," citing also this Court's opinion in *Paragon Jewel Coal Co. Inc.* v. *Commissioner,* 380 U.S. 624, decided April 28, 1965; and

(2) on the merits, petitioner did not acquire an economic interest under the 1952 contract because said contract was merely a "rearrangement" of the 1935 contract which, in the prior case of *CBN Corp.* v. *United States,* both the majority and minority agreed did not afford petitioner an economic interest in the mineral in place.

On October 14, 1966, the Court of Claims entered its decision and opinion in the case of *Union Bag-Camp Paper Corp.* v. *United States,* 366 F.2d 1011 (Ct. Cls. Nos. 147-64, 150-64) (Appendix F, infra, pp. 1f-8f), wherein it held that collateral estoppel applied where the parties and contracts were identical despite an intervening decision of the Court of Appeals for the Fifth Circuit (*Dyal* v. *United States,* 342 F.2d 248) which had *specifically* disagreed in part with the prior *Union Bag-Camp* case decided by the Court of Claims. The Court of Claims based its decision to apply collateral estoppel, nevertheless, on the grounds that the disagreement of the Fifth Circuit was not a *significant* change in legal climate. A concurring opinion argued that collateral estoppel should not apply because the intervening Fifth Circuit case "clouded the legal sky * * * noticeably enough to dissolve estoppel," citing the decision in the instant *CBN* case.

On October 14, 1966 the Court of Claims also denied petitioner's motion for rehearing and reconsideration of the instant case which motion was based, *inter alia,* on the grounds that reference to the case of *Shamrock Oil and Gas Corp.* v. *Commissioner,* 35 T.C. 979 (1961), aff'd. 346 F.2d 377 (C.A. 5th, 1965), cert. denied, 382 U.S. 892. (Excerpts Reprinted in Appendix G, *infra,* pp. 1g-16g) showed that petitioner conformed to the requisites of an economic interest set out in *Food Machinery and Chemical Corp.* v. *United States, supra.*

REASONS FOR GRANTING THE WRIT

1. In refusing to apply collateral estoppel the Court of Claims adopted a definition of a change in legal atmosphere which is in direct conflict with a decision of this Court, a decision of the Court of Appeals for the Seventh Circuit, and all known precedent.

In the instant case, the Court below agreed that there had been no change in the applicable statutory provisions, and that the parties and facts are identical, but held that an alteration in *its own approach* to the overall general problem in an intervening case constituted a change in legal atmosphere or climate sufficient to preclude the application of collateral estoppel. This rule was adopted by the Court below even though the intervening case made no reference to the prior case; the cases are completely divergent in their facts; and each was correctly decided under the law which remained unchanged. Such rule is in direct conflict with the decision of this Court in *Commissioner* v. *Sunnen,* (1947) 333 U.S. 591, and with the decision of the Court of Appeals for the Seventh Circuit in *Lynch* v. *Commissioner,* (C.A. 7th, 1954) 216 F.2d 574 (Appendix H, *infra,* pp. 1h-18h).

In *Sunnen* this Court stated that collateral estoppel applies when the issues, facts and parties are identical and only the taxable years differ, unless there has been a change or development in the *controlling legal principles or applicable legal rules.* Although this Court indicated strongly that the intervening decision which changes the legal principles or rules must be that of this Court or of a State Court of superior jurisdiction, See *Blair* v. *Commissioner,* 300 U.S. 5 (1937), it most clearly held that collateral estoppel must be applied where the legal rules remain unchanged. Except for the decision of the Court below in the instant case, no Court, to petitioner's knowledge, has ever held that collateral estoppel may be rendered

inoperative by an intervening decision in an entirely unrelated case involving a dissimilar legal issue and completely dissimilar facts. The legal principles or rules applicable in the instant case have remained unchanged since *Palmer* v. *Bender*, 287 U.S. 551 (1933).

2. The Court of Claims erred in predicating a change in legal atmosphere on its subjective change of mind regarding the requisite configuration of facts.

In *Lynch* v. *Commissioner, supra,* the Seventh Circuit held that a change in the "appraisement" to be placed upon the facts does *not* constitute a change in legal atmosphere and that a change in atmosphere can only be brought about by a change in the statute or by a decision of *this* Court. Similarly, in *Dr. Salsbury's Laboratories* v. *I. D. Russel Co. Laboratories,* (C.A. 8th, 1954) 212 F.2d 414, 416, the Eighth Circuit indicated that a change in legal atmosphere must be a *decisive* one in order to avoid the application of collateral estoppel. In the instant case, however, the Court below did not find that a decisive change had occurred. It held merely that a "material alteration in approach" (Appendix A, *infra,* pp. 5a, 8a) by the Court itself is all that is required, even though the prior and intervening cases were decided upon entirely different facts and circumstances and both cases were correctly decided under unchanged and long-established legal principles. That there has been no change in legal principles is clearly manifested by the opinions of this Court in *Paragon Jewel Coal Co.* v. *Commissioner,* 380 U.S. 624 (1965) and *Commissioner* v. *Brown,* 380 U.S. 563 (1965), both entered after the lower Court's decision in the prior *CBN* case.

It is apparent on the face of the decision in the instant case that the Court below refused to apply collateral estoppel and strained to find a change in legal atmosphere

because it had already reappraised the facts of both the prior *CBN* case *and* the intervening *Tidewater* case and resolved to recharacterize *both* of them. In short, the Court of Claims had not changed the legal climate by its decision in *Tidewater*—it changed its mind with regard to the prior *CBN* case. Compare the vague, indefinite groping of the lower Court's attempt to obviate the application of the doctrine of collateral estoppel here with that same Court's decision in *Union Bag-Camp Paper Corp.* v. *United States, supra*, where it *applied* collateral estoppel despite the fact that an intervening decision by the Fifth Circuit had specifically disagreed with the first *Union Bag-Camp* decision, and despite the urging of a concurring judge of the Court of Claims that the rule of the instant case prevented the application of collateral estoppel. Obviously, then, this new rule as to "change in legal atmosphere" applies at the whim of the lower Court to revive the litigation of decided issues or to let them lay at rest.

The Court below has done exactly what the Seventh Circuit held could not be done—the Court below has reconsidered the facts with a "new set of eyes," and concluded that it could have decided the prior *CBN* case by reference to the 1935 contract instead of the 1952 contract. But the decision in that case had become final. In order to reverse itself, the Court below avoided collateral estoppel by finding that the doctrine could not apply *solely* because it had decided to reconsider the issue; an alternative clearly prohibited by the law of collateral estoppel as defined by this Court in *Commissioner* v. *Sunnen, supra*. In fact, the Court of Claims itself had previously rejected such a radical departure from precedent in *Hercules Powder Co.* v. *United States*, 337 F.2d 643, 648 (Ct. Cls. 1964). Strangely, however, the Court below in the instant case cited the *dissenting* opinion in that case which argued, in effect, that collateral estoppel *never* applies in tax cases. Accordingly, the Court below has not only twisted the doctrine of collateral estoppel out of all acceptable context but has done so on

the basis of *dissenting* language in a case which it did not overrule and which *dissenting* language was again *rejected* in the later *Union Bag-Camp* case, *supra*. Even in *Hercules Powder*, however, each intervening case had cited and attempted to distinguish the preceding one. Here, the intervening *Tidewater* case did not make one single reference to the prior *CBN* case and there is absolutely no similarity in either the pertinent facts or the applicable law of the two cases.

3. The Court of Claims distorted the term "change in legal atmosphere" in order to change its findings of fact in both the prior and intervening cases.

In *Commissioner* v. *Sunnen*, 333 U.S. 591, 601, this Court stated that:

> "Of course, when a question of fact essential to the judgment is actually litigated and determined in the first tax proceeding, the parties are bound by that determination in a subsequent proceeding even though the cause of action is different. *And if the very same facts and no others are involved in the second case, a case relating to a different tax year, the prior judgment will be conclusive as to the same legal issues which appear, assuming no intervening doctrinal change.*" (Emphasis supplied.)

In the first *CBN* case (Appendix C, *infra*, pp. 1c-25c), the Court of Claims found as a fact and held that the 1935 contract was "immaterial" and that petitioner's right to the depletion allowance depended entirely upon the provisions of the 1952 contract. Addressing itself to the latter contract, the Court concluded that under it petitioner had surrendered a valuable property in exchange for a royalty interest in the mineral in place. These findings became final.

In the intervening *Tidewater* case (Appendix D, *infra*, pp. 1d-15d), the same Court found that the transferor had *not* obtained a royalty interest in the mineral, nor was any of its mineral being depleted under the transferred allowables. *Absent* such factors, the Court felt constrained to discuss, as argued by defendant United States, whether the transferor had otherwise acquired a depletable interest. Concluding that it had not, the decision was entered for Tidewater Oil Company. These findings and conclusions became final.

In the instant case, however, the Court below completely ignored the essential teaching of *Sunnen* that any alleged change in law be doctrinal in scope. It then concluded that collateral estoppel could be avoided by first reconstruing *Tidewater* as involving a transferor "who received *royalties*" (Appendix A, *infra*, p. 5a) and then holding that the similarity of language used by it in refuting the similar contentions of defendant United States in both cases constituted a change in legal atmosphere. Thus, it felt free to reconsider both of the *CBN* cases to hold that, as petitioner did not have an economic interest under the 1935 contract, it *could not* acquire such interest under the 1952 contract. The original holding in the prior *CBN* case that under the 1952 contract petitioner acquired a royalty was neither discussed nor rejected.

In fact, then, what the Court below has done in the instant case is to reconsider its decisions in *both* the prior *CBN* case and the *Tidewater* case, and to redecide both cases on the basis of facts not previously litigated in either case. It first reconsidered the instant case on the basis of *assumed* facts that it would now deem pertinent had they been before it in the prior case. It then reversed the first *CBN* decision on the rationale of what facts it now feels should have been determinative if presented for decision in *Tidewater* and prior *CBN*, even though the cases involved totally different issues.

Petitioner submits that there has been no change in legal atmosphere arising from the litigated facts in these cases. If there has been any change it has *not* been concerned with situations involving the long-standing indicia of an economic interest in minerals. Clearly, there has been no change in law with regard to the rights of royalty holders, the existence of a royalty being a question of fact. In any event, no change in legal atmosphere can alter an ultimate fact once finally determined. A doctrinal change may only alter the *legal relevance* of an evidentiary fact. *Lynch* v. *Commissioner, supra* (Appendix H, *infra*, pp. 1h-18h).

There has been no doctrinal change in this area of the law as required by *Commissioner* v. *Sunnen, supra.* In the prior *CBN* case, the Court below held that the factual circumstances of the 1952 contract afforded petitioner an overriding royalty. There has been no change in the facts or in the law pertaining to the depletion rights of a holder of an overriding royalty. The Court below used an alleged change in legal atmosphere as a lever to enable it to redecide the issue on the basis of other facts not pertinent to this issue.

The Court below did not, and could not, find that a change in legal atmosphere had occurred, either in the tax treatment of a royalty interest or with regard to the interpretation of the specific contracts. As patently manifested in the opinion in the instant case, the only change resulted from a reappraisal of the presumed facts with a different "set of eyes". It is submitted that the Court below alleged a change in legal atmosphere solely as a vehicle to change the findings of fact in *both* the prior *CBN* case and the *Tidewater* case. This is directly contrary to the teaching of this Court in *Commissioner* v. *Sunnen, supra.*

4. The opinion and decision of the Court of Claims in the instant case nullifies collateral estoppel as a rule of law in tax cases and makes its application dependent upon the thought processes of the judges or the arguments of the parties.

The Court below held that collateral estoppel does not apply, even though the facts, parties and issues are identical, if there has been a change in legal atmosphere. It defined a change in legal atmosphere as "some marked advance or alteration in relevant orientation, approach, reasoning, or principles". These terms were clearly meant to be applied disjunctively as the Court went on to hold that the intervening *Tidewater* case precluded the application of collateral estoppel because it "represents a material alteration in approach to the overall depletion question". Comparison of the prior *CBN* case and the intervening *Tidewater* case, however, discloses that the "alteration in approach" consist merely of similarities in *language* in the dissenting opinion in *CBN* and the majority opinion in *Tidewater*, while the facts and issues are completely dissimilar. Closer comparison reveals that the similarities in language resulted from discussion by the Court in *refuting* contentions made by defendant United States in seeking to apply, as rules of law, words and phrases twisted out of this Court's opinion in *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308 (1956) in an attempt to defeat the claims of both taxpayers for the depletion allowance.

In the first *CBN* case, the defendant contended that petitioner could not have acquired an economic interest because it was not essential to extraction of the mineral under the 1952 contract. In *Tidewater*, the defendant contended that Elm Oil Company, the transferor of the oil allowable, and not Tidewater Oil Company had the economic interest because the transferor *was* essential to the extraction of the mineral. The Court below *rejected*

the argument in both cases; in *CBN* because there is no requirement that a royalty holder be essential to extraction in the sense that it can compel production, and in *Tidewater* because the facts showed that the transferor did *not* receive a royalty and was not, in any event, essential to extraction. The only possible change in atmosphere in the *Tidewater* case is a negative recognition that, in proper context, a taxpayer essential to extraction *might* qualify for the depletion allowance under *Southwest Exploration* where none of the standard factual criteria were met. Certainly *Southwest Exploration* does not stand for the proposition for which it was cited by the Court below, i. e., that the *only* taxpayer entitled to depletion is one making a contribution that is essential to extraction. If that be the case, no person could ever acquire an economic interest by purchase!

The unmitigated thrust of the decision of the Court below is that only *it* ever knows whether there has ever been a change in legal atmosphere and what constitutes such a change. Under this doctrine, there can never be a predictable end to litigation of tax issues which span more than one taxable period. Both the Government and taxpayers are thus free to relitigate identical issues year after year regardless of the outcome of the prior litigation. Certainly the purely subjective test employed by the Court below was not intended by this Court in *Commissioner* v. *Sunnen*, *supra*.

5. If the legal atmosphere was changed it was not changed in the case cited by the Court of Claims.

In truth, there has been no change in legal atmosphere pertaining to the economic interest concept. This Court in *Paragon Jewel Coal Co.* v. *Commissioner*, *supra*, merely reiterated long-established rules and, if anything, made clear that petitioner in the instant case had an economic interest in the mineral under both the 1935 and 1952 con-

tracts. In *Paragon Jewel Coal Co.*, this Court pointed out that a sharing of the proceeds of sale and an interest in the mineral for the life of the deposit remained the prime criteria for determining the existence of an economic interest. Under the 1935 contract, petitioner met both these tests. It had a prior right to the gas produced for the life of the field, specific reserves were dedicated to it under the contract, and it paid for the gas with thirty per cent of the carbon black manufactured. If it elected to sell the gas rather than use it to manufacture carbon black, it shared the sales proceeds in excess of 2 cents per thousand cubic feet equally with Shamrock Oil and Gas Company. Under Texas law such a contract affords a holder an interest in the mineral leases subject to the contract. See, *Guffey* v. *Utex Exploration Co.* 376 S.W. 2d 1. (Tex. Civ. App., 1964). Likewise under the 1952 contract, petitioner retained all of the necessary attributes of an economic interest. It received an overriding royalty, for the life of the deposit, payable out of the gross sales price of the mineral.

Petitioner's clear economic interest under the 1935 contract was even recognized by the Court below when, subsequent to its *Tidewater* decision, it decided the case of *Food Machinery & Chemical Corp.* v. *United States,* 348 F.2d 921 (Appendix E, *infra,* pp. 1e-16e), where it held that a taxpayer in a situation identical to that of petitioner under the 1935 contract *did* have an economic interest in the mineral. Accordingly, if any change in legal atmosphere has occurred, it occurred in the later *Food Machinery* case, which itself appears to be directly contrary to the decision of this Court in *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362 (1938). The Court below, however, refused to allow petitioner to show that it meets that Court's "new" criteria.

In any event, even assuming *arguendo* that the Court below has changed its "approach" to depletion matters and that such change constitutes a change in legal atmos-

phere or climate, it erroneously cited the *Tidewater* case as exemplifying such change in order to avoid applying the new approach to petitioner.

In the first *CBN* case, the issue before the Court below was whether petitioner had acquired an economic interest when it exchanged its 1935 contract for the new 1952 contract. The Court held that it had and, although in *obiter dictum* it indicated a belief that petitioner did not have the requisite interest under the 1935 contract, it termed that contract "immaterial" (Appendix C, *infra*, p. 17c). This was also the position of the parties (See certified record in *CBN Corp.* v. *United States*, Court of Claims Docket No. 243-59, Plaintiff's Brief, pp. 21-23, Defendant's Brief, pp. 1-3, 17-31). Accordingly, the background and circumstances of the 1935 contract were never presented to the Court. In the instant case, however, the Court below, after citing *Tidewater* as representing the change in legal atmosphere or climate, addressed itself to the merits and held that the 1935 contract was determinative of the question. It also cited the *Food Machinery* case as an example of what contractual circumstances are required to afford a taxpayer an economic interest under its new approach. Subsequently, however, it denied petitioner's motion for a rehearing in which petitioner asked to be allowed to show that it *met* the criteria set out for the first time in the *Food Machinery* case. Petitioner moved for the rehearing and offered to establish the identical facts found by the Tax Court in the case of *Shamrock Oil & Gas Company* v. *Commissioner*, 35 T.C. 979 (1961), aff'd. 346 F.2d 377 (C.A. 5th, 1965) cert. denied, 382 U. S. 892 (Excerpts Reprinted in Appendix G, *infra*, pp. 1g-16g). In that case, the Tax Court discussed and found facts pertaining to the very same 1935 contract which put said contract squarely within the four corners of the criteria subsequently deemed determinative by the Court below in the *Food Machinery* case. If that case had been cited by the Court below for the alleged change in legal atmosphere, however, justice and fair

dealing would have mandated consideration of the facts and circumstances pertaining to and leading up to the 1935 contract. These facts were not in the record as they were specifically held not pertinent by the Court and had never been considered pertinent by the parties. (See certified record in *CBN Corp.* v. *United States*, Court of Claims Docket No. 243-59, Defendant's Proposed Findings of Fact, p. 12).

Instead, the Court below based its alleged change on the *Tidewater* case, reexamined the 1952 contract by reference to the *dictum* in the first *CBN* case regarding the 1935 contract and then reversed its prior decision. Thus the Court has changed the rules suddenly and without warning and by so doing it has denied petitioner its day in court. Petitioner has been saddled with a new burden of proof which was established by the Court below *after* its case was tried and has been penalized for failing to meet those criteria.

6. The Court of Claims redecided the economic interest issue on the basis of an assumption not previously litigated, thus depriving petitioner of the right to show that it met all the requirements.

After concluding that collateral estoppel did not apply because of an alleged change in legal atmosphere, the Court below held that it was free to consider the merits of the issue "anew" (Appendix A, *infra*, p. 8a). Yet, it did not do so! Instead of reconsidering all of the facts in the light of its new criteria for determining the existence of an economic interest (whether as set forth in either *Tidewater* or in *Food Machinery*), the Court below began its reconsideration with the unfounded *assumption* that petitioner did not have an economic interest under the 1935 contract. This assumption was based solely on *dictum* in the prior *CBN* case where that question was not presented and ultimately held "immaterial" by the

Court itself. Proceeding from that assumption, however, the Court below then went on to hold that the 1952 contract was merely a "rearrangement" which did not change the status as between the parties and, accordingly, could not have afforded petitioner an economic interest in the mineral, because petitioner was not "essential to extraction" *thereunder*. However, under the 1935 contract, petitioner *was* essential to extraction and could compel production (See and compare *Food Machinery & Chemical Corp.* v. *United States, supra,* and excerpts from *Shamrock Oil and Gas Co.* v. *Commissioner, supra,* both reprinted in Appendices E and G, *infra,* pp. 1e-16e, 1g-16g), but the Court below refused to go back beyond the 1952 contract to consider that factor.

Clearly, then, petitioner has been "whipsawed" by the Court below. The finding in the prior *CBN* case that the 1952 contract was entirely new and controlling has not been disturbed. The Court below has redecided the case on the basis of a contract not heretofore in issue and, at the same time, has precluded petitioner from putting that contract in issue.

The decision below thus presents a circuitous anomaly. First, the Court below *assumed* that under the 1935 contract petitioner was a mere "purchaser" and did not share in the proceeds from the extraction and sale of the mineral and, accordingly, under *Helvering* v. *Bankline Oil Co., supra,* it did not possess an economic interest. Next, referring to the 1952 contract where petitioner *did* share in the proceeds of extraction and sale, the Court below held that it does not have an economic interest because it could not compel production, and even though it was essential to production under the new test of the *Food Machinery* case, that essentiality terminated when the new 1952 contract was negotiated. At the same time the Court below held that the 1952 contract was merely a "rearrangement" of the 1935 contract which petitioner was prevented from litigating in the Court

because, although the facts had not changed, allegedly the "legal atmosphere" had.

This anomaly is even more clearly illustrated by reference to the 1935 contract where petitioner, whose interest admittedly ran with the land and constituted an interest in the lease, could compel production, and to the 1952 contract which afforded petitioner a royalty interest which never allows the holder to compel production. Of course, the fact is that in *Food Machinery*, the Court below had changed its mind as to what criteria it would henceforth require to sustain the existence of an economic interest but refused to recognize that petitioner in fact complies with these new criteria.

Petitioner submits that under these new criteria petitioner had an economic interest in the mineral pursuant to the 1935 contract, and even if the 1952 contract was merely a "rearrangement" and not a new contract, petitioner's interest was further strengthened when it obtained the right to share *directly* in the proceeds of extraction and sale. If petitioner was essential to production under the 1935 contract and the 1952 contract was only a rearrangement thereof, petitioner must have maintained its essentiality.

7. On the merits of the issue petitioner has an economic interest under the principles established by this Court in a long series of cases.

The Court below held that in the absence of a free or leasehold interest in the mineral, a taxpayer cannot have an economic interest in the mineral unless he makes an "indispensable contribution" within the meaning of that phrase as used by this Court in *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308 (1956) and that the term, "indispensable contribution", means that a taxpayer must be "essential to the drilling or extraction operation" (as

in *Food Machinery*) *before* an economic interest can exist. Not only does such an interpretation of this Court's language automatically preclude any taxpayer from ever *purchasing* an economic interest in minerals but it makes the *consideration* given for the mineral interest determinative of the issue. Unless the consideration itself constituted an economic interest, the Court below holds that an economic interest cannot be obtained.

This definitely distorts the language of *Commissioner* v. *Southwest Exploration Co.* and ignores the warning of this Court in that case, and in subsequent cases, that the rule there applied should not be twisted out of the context of its unique facts. See, *Paragon Jewel Coal Co.* v. *Commissioner*, *supra*, at pp. 638, 638, where this warning was again expressed. What the Court below has done is to reverse, in effect, the long line of decisions by this Court commencing with *Palmer* v. *Bender*, 287 U.S. 551 (1933), which established the criteria for determining an economic interest and has substituted therefor, as being paramount, *its* interpretation of the rule of *Commissioner* v. *Southwest Exploration Co.*; *supra*. This despite all of the recent decisions of this Court which indicate that the trend of this Court's thinking on the subject has progressed in a direction diametrically opposite to that now taken by the Court below.

In *Paragon Jewel Coal Co.* v. *Commissioner*, *supra*, and *Commissioner* v. *Brown*, *supra*, this Court clearly indicated that the *consideration* given for a mineral interest is to be given little weight and that the necessity of looking to the production and sale of the mineral for *income* determines the existence of an economic interest. If exhaustion of the mineral will exhaust income, an economic interest obtains.

Further, the Court below has not only obliterated the standard rules for determining the existence of an economic interest established by this Court, it has in fact utilized the criteria for a sale or exchange in order to hold

that petitioner does not have an economic interest in the mineral. See, *Burnet* v. *Harmel*, 287 U.S. 103 (1932). If it had held, however, that petitioner had *exchanged* its rights under the 1935 contract for the payments received under the 1952 contract, the Court below should have concluded that the amounts being received by petitioner under the 1952 contract constitute capital gains.

It does not suffice to avoid this conclusion to hold that the 1952 contract was a "rearrangement"—a term or status apparently foreign to contract law. See, Restatement of Contracts, Sections 223, 406, 408, 432. That the Court below realized this is apparent from its opinion wherein it discussed the differences between the two contracts and cited such differences, where possible, to petitioner's detriment. (See Appendix A, *infra*, p. 11a, Footnote [5], where the Court below stated that a clause in the 1952 contract "indicates a material change in agreement between the parties"). Yet it circumvented the aspects favorable to petitioner's contentions by inventing the term "rearrangement" in order to deprive petitioner of its day in Court. At the same time, it tacitly admitted that the new contract "rearranged" the "respective *interests* of the parties." (Appendix A, *infra*, p. 11a). As the Court below admitted, the interest held by petitioner under the 1935 contract ran with the land. As such it was an interest in the land and, hence, an interest in the mineral in place. The 1952 contract substituted (or added?) a royalty interest for the right to compel deliverance of the gas. The Court below thus held that for depletion purposes this was an *exchange* while for capital gain purposes only a *rearrangement* took place. Petitioner submits that if this truly constituted a mere *rearrangement*, then petitioner retained under *both* contracts every requisite for an economic interest in the mineral.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDICES

APPENDIX A

Opinion, Findings of Fact and Conclusions of Law of the United States Court of Claims

IN THE

UNITED STATES COURT OF CLAIMS

No. 263-62

(Decided July 15, 1966)

CBN CORPORATION, (FORMERLY COLUMBIAN CARBON COMPANY) v. THE UNITED STATES

ROBERT J. CASEY, attorney of record, for plaintiff. CLARK, CARR & ELLIS; THOMAS J. MCCOY, JR., THOMAS E. TYRE, JOHN A. CRAIG; and HARRY J. GERRITY, of counsel.

MITCHELL SAMUELSON, with whom was ASSISTANT ATTORNEY GENERAL MITCHELL ROGOVIN, for defendant. C. MOXLEY FEATHERSTON, LYLE M. TURNER and PHILIP R. MILLER, of counsel.

Before COWEN, *Chief Judge*, LARAMORE, DURFEE, DAVIS, and COLLINS, *Judges*.

ON PLAINTIFF'S MOTION AND DEFENDANT'S CROSS-MOTION FOR SUMMARY JUDGMENT

DURFEE, *Judge*, delivered the opinion of the court:

This is an action to recover an alleged overpayment of income taxes and interest for the years 1955 and 1956 in the amount of $274,562.75. The parties by joint stipulation have agreed that four of the six separate counts included in the petition, namely counts 2, 3, 4 and 6, are to be dismissed with prejudice. These cross-motions for summary judgment pertain to the remaining counts—counts 1 and 5.

The issue before the court is whether plaintiff had a sufficient economic interest in natural gas in place to entitle it to participate in the depletion allowance for income tax purposes. This court in *CBN Corporation* v. *United States*, 164 Ct. Cl. 540, 328 F.2d, 316 (1964) held that plaintiff, who before 1952 was a buyer of gas from Shamrock Oil Corporation, acquired an economic interest in the gas in place as a result of a 1952 agreement with Shamrock. The 1952 agreement relieved plaintiff of the obligation of buying gas from certain reserves of Shamrock (which gas plaintiff used either to produce carbon black or to sell to others) and instead, gave plaintiff a payment for the gas from the set-aside reserves sold by Shamrock to others. As a result of holding an economic interest, plaintiff was entitled to take the depletion allowance in computing its 1953 taxes. The facts in this case are the same as in the prior *CBN* case, *supra*. Only different tax years are involved.[1]

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[1] The prior *CBN* case allowed recovery under §§ 23 and 114 of the 1939 Internal Revenue Code. 26 U.S.C. §§ 23 and 114 (1952 ed.). Since the tax years 1955 and 1956 are involved in the present litigation, we must look to the depletion laws contained in the 1954 Internal Revenue Code. Those sections (§§ 611 and 613) are substantially the same as their 1939 Code predecessors. Sections 611 and 613 of the 1954 Code, 26 U.S.C. §§ 611 and 613 (1964 ed.) read in relevant part as follows:

§ 611. Allowance of deduction for depletion.

(a) General rule.

In the case of mines, oil and gas wells, * * * there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, * * * such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. * * *

§ 613. Percentage depletion.

(a) General rule.

In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611

Plaintiff, therefore, maintains that the doctrine of collateral estoppel precludes defendant from opposing its summary judgment motion on grounds already litigated in the prior opinion. Practically speaking, plaintiff's argument is that, since the facts and legal arguments of the prior *CBN* case and this case are identical, the court must render judgment for plaintiff.

Plaintiff's doctrinaire approach is based on the Supreme Court's approach to collateral estoppel as set forth in *Commissioner* v. *Sunnen*, 333 U.S. 591 (1948). There the Court stated at 597-598:

> * * * where the second action between the same parties is upon a different cause or demand, the principle of *res judicata* is applied much more narrowly. In this situation, the judgment in the prior action operates as an estoppel, not as to matters which might have been litigated and determined, but "only as to those matters in issue or points controverted, upon the determination of which the finding or verdict was rendered." * * * But matters which were actually litigated and determined in the first proceeding cannot later be relitigated. Once a party has fought out a matter in litigation with the other party, he cannot later renew that duel. In this sense, *res judicata* is

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shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property * * *.

(b) Percentage depletion rates.

The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * *

> usually and more accurately referred to as estoppel by judgment, or collateral estoppel. * * *

It is the above quoted language which plaintiff uses as the foundation of its argument. The Supreme Court in *Sunnen, supra,* however, went on to further refine the rules for applying collateral estoppel. The Court stated at p. 599:

> But collateral estoppel is a doctrine capable of being applied so as to avoid an undue disparity in the impact of income tax liability. A taxpayer may secure a judicial determination of a particular tax matter, a matter which may recur without substantial variation for some years thereafter. But a subsequent modification of the significant facts *or a change or development in the controlling legal principles* may make that determination obsolete or erroneous, at least for future purposes. If such a determination is then perpetuated each succeeding year as to the taxpayer involved in the original litigation, he is accorded a tax treatment different from that given to other taxpayers in the same class. As a result, there are inequalities in the administration of the revenue laws, discriminatory distinctions in tax liability and a fertile basis for litigious confusion. * * * [collateral estoppel] is not meant to create vested rights in decisions that have become obsolete or erroneous with time, thereby causing inequities among taxpayers. [Emphasis added.]

at 600:

> * * * As demonstrated by *Blair* v. *Commissioner,* 300 U.S. 5, 9, a judicial declaration intervening between the two proceedings may so *change the legal atmosphere* as to render the rule of collateral estoppel inapplicable. * * * [Emphasis added.]

In regard to the aforementioned, *change or development in controlling legal principles* or *change in the legal atmosphere* it has been stated that these standards do not mean that the earlier decision must have been overruled or that the second ruling be inconsistent with the first. The above italicized language means rather that the "second Court should be freed from the prior determination if there has been some marked advance or alteration in relevant orientation, approach, reasoning, or principles." *Hercules Powder Co.* v. *United States,* 167 Ct. Cl. 639, 649, 337 F.2d, 643, 648 (1964) (dissenting opinion). That such a marked alteration in approach to the problem at hand exists is evidenced by the recent decision of this court in *Tidewater Oil Company* v. *United States,* 168 Ct. Cl. 457, 339 F.2d 633 (1964). We held in *Tidewater* that transferors of oil "allowables"[2] in the East Texas Oil Field, who received royalties on each barrel of oil produced under the transferred allowables, did not have the requisite interest in the oil in place to enable them to qualify for depletion allowances. A comparison of the reasoning and approach used in the first *CBN* case and the *Tidewater* case lucidly underscores the change of course in our approach to depletion matters.

A bothersome point in the prior *CBN* case was the lack of a fee or leasehold interest by plaintiff in the oil-producing properties. Placing reliance on *Commissioner* v. *Southwest Exploration Co.,* 350 U.S. 308 (1956), this Court stated at 164 Ct. Cl. 550: "It is not necessary that the holder of an economic interest have title to the prop-

[2] The Texas law limits the production from each oil well by assigning a monthly maximum production "allowable" to each well. If any well is shut down because of an excessive amount of salt water, the owner of that well may assign his oil "allowable" to another operator, who may then produce this additional amount of oil under his own oil lease.

erty." However, in the later *Tidewater* case, this blanket rule was somewhat refined as follows:

> * * * At the outset it should be noted that aside from *Southwest Exploration* no Supreme Court decision has found a taxpayer possessing the requisite interest in the mineral in place who did not have either a fee or a leasehold interest in the oil-producing property itself. This apparent departure from prior doctrine can best be explained on the grounds that the granting of discovery depletion in that case served the purposes for which the allowance was created. That is, the upland owners in that case contributed *real property* which was essential to the *discovery, drilling,* and *extraction* of the oil. * * * [168 Ct. Cl. at 466—Emphasis in original.]

Thus, the holding of non-necessity of title or leasehold interest of *Southwest,* regarded as a blanket exception or break from precedent by the Court in *CBN,* was re-interpreted in *Tidewater* to be a variable; that is, the requirement of fee or leasehold *may* be disregarded *in certain instances* where its application would thwart the purpose for which depletion allowances were created. The necessity of title or leasehold rule was recognized to be an elastic one—one that could be stretched in certain instances, as in *Southwest,* rather than one to be strictly adhered to or, conversely, completely disregarded. That this is the correct interpretation is evidenced by the very limited holding by the Supreme Court itself in *Southwest* at 350 U.S. 317:

> * * * We decide only that where, *in the circumstances of this case,* a party essential to the drilling for and extraction of oil has made an *indispensable contribution* to the use of real property adjacent to

> the oil deposits in return for a share in the net profits from the production of oil, that party has an economic interest * * *. [Emphasis added.]

See also *Paragon Jewel Coal Co.* v. *Commissioner,* 380 U.S. 624, 637-38 (1965).

The above quoted limited holding of *Southwest* refers to an *indispensable contribution* by the party seeking the depletion allowance. Footnote 5 of the prior *CBN* case refers to *Southwest* in the following manner, at p. 552:

> * * * The Court does mention in *Southwest* that the site furnished was essential to the drilling contract, but this was only one of the elements mentioned by the Supreme Court. We have seen no case that holds that a party must be essential to a drilling contract in order to have an economic interest. * * *

Compare, however, the approach used by the court in *Tidewater* when the court, in analyzing the facts, concluded that the transferors of allowables had not made an *indispensable contribution* to the use of the property:

> * * * Their [the transferors] contribution was personal property rather than real property; it was at best indispensable for the extraction of only part of the oil; it was not instrumental in the acquisition of the lease, *nor was it essential to the drilling operations.* * * * [at 467—Emphasis added.]

This court in attempting to determine the meaning of the Supreme Court's language of "indispensable contribution" decided in *Tidewater,* upon further thought and consideration, that such language meant that a major factor in determining economic interest of one seeking depletion was the determination of whether or not that party was *essential*

to the drilling operation (or extraction of minerals).[3] This court's understanding of *Southwest,* in the *Tidewater* case, was thereafter confirmed by the Supreme Court in *Paragon Jewel Coal Co.* v. *Commissioner, supra,* 380 U.S. at 637-38. Such reasoning represents a material alteration in approach to the overall depletion question from our reasoning in the prior *CBN* case.

Since, as we have shown, our approach to this type of case has changed considerably, we are free to consider anew the issue in this case on its merits. Immediately prior to 1952, Shamrock Oil and Gas Corporation was engaged in the production of natural gas from lands owned or leased by that company in Moore County, Texas. Under various agreements CBN and Shamrock had entered into a certain arrangement for the sale of gas to CBN. Under the agreements, Shamrock was responsible for bringing the natural gas to the surface. Shamrock then removed liquid hydrocarbons from the gas. After such removal, about 95 percent of the original or raw gas remained. (The remainder is sometimes referred to as residue gas). CBN, which

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[3] See a later decision of this court, Food Machinery Corp. v. United States, 172 Ct. Cl. —, 348 F.2d 921 (1965) where we held that certain contributions of taxpayer (namely the construction of 4 electric furnaces worth $20,000,000.00) were *essential* to the mining of shale. The requisite of essentiality to the drilling or extraction operation seems now to be well established.

Plaintiff has relied on Food Machinery mainly for the proposition that the requirement of fee or leasehold is no longer important in deciding depletion cases. However, as we have pointed out, the leasehold or fee rule is not a rigid one, and may be disregarded in instances when its application would subvert Congressional intent. Food Machinery was just such a situation. Plaintiff's economic interest in Food Machinery was so strong that the absence of a leasehold or fee interest could not divest plaintiff of depletion rights. In fact, we stated in Food Machinery that the facts in that case on the question of economic interest were stronger than in Southwest. The holding in Food Machinery was therefore no more than an adherence to the principles set out in Southwest.

operated a carbon black plant in the area, then had a right and obligation to purchase a certain amount of such residue gas from Shamrock. The amount that CBN had a right to purchase was a fractional part of the residue gas, which was referred to as "dedicated reserves." From these dedicated reserves there was to be available to CBN a minimum of 30 million cubic feet of gas per day. CBN was obligated to purchase the aforsaid minimum amount, and had first option to purchase other gas available from the reserves. CBN was also given the right to cease burning the gas at any time, in which event it could resell to other purchasers. In the latter event, different terms of paying Shamrock for the gas were provided. It is evident that under these arrangements CBN held no economic interest in the gas.[4] The test for economic interest is set out in *Commissioner* v. *Southwest Exploration Co., supra,* at p. 314:

> * * * a taxpayer is entitled to depletion where he has: (1) "acquired, by investment, any interest in the oil in place," and (2) secured by legal relationship "income derived from the extraction of the oil, to which he must look for a return of his capital."
> * * *

Plaintiff did not qualify under part (1) of the above test since it held only an economic advantage, not an economic interest in the oil in place. Plaintiff was merely a purchaser of the gas.

Helvering v. *Bankline Oil Co.,* 303 U.S. 362 (1938) authoritatively held that a mere purchaser is not entitled to depletion. In that case the taxpayer purchased the gas before removal of the hydrocarbons. Plaintiff in this case is further removed from the gas in place since its purchases were not made until after the hydrocarbons were removed.

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[4] Both the majority and dissenting opinions in the prior *CBN* case were in agreement with the fact that CBN Corporation had no economic interest in the oil in place prior to 1952.

We must now determine whether or not the 1952 contract between plaintiff and Shamrock so altered their relationship as to change plaintiff's interest from one of economic advantage to economic interest in the gas in place, Upon analysis of the contract, we think it does not.

By 1952 both parties desired to have a different arrangement of their agreement. Plaintiff wished to shut down its carbon black plant and to resell all of the gas bought from Shamrock. Shamrock, in turn, wished to sell the gas to another company at higher profits. Both parties then decided that it would be advantageous to arrange for the resale of all of the gas (including that volume that plaintiff was obligated to purchase) by Shamrock in its own name. That this was the parties' intent is shown by the 4th, 5th and 6th paragraphs of the preamble to the 1952 contract which read in part as follows:

> WHEREAS [CBN] has notified Shamrock of its intention to shut down its carbon plant * * * and * * * desires to effect a resale of volumes of gas it is authorized to resell under the terms and provisions of the aforesaid contracts; the [pre-1952 agreements] and
>
> WHEREAS * * * the conditions under which such volumes would be delivered and received would require an agreement or arrangement between Shamrock and the purchaser * * *; * * * the parties hereto having considered such matters, have concluded that it would be more economical and convenient to arrange for the resale of the aforesaid volumes to be made by Shamrock in its own name and on its responsibility as between the seller and purchaser of such gas and that an accounting between the parties hereto with respect to such resale volumes be made on a basis mutually satisfactory in lieu of the accounting between the parties required under the terms of the aforesaid contracts * * *; and

> WHEREAS Shamrock is willing to release [CBN] from its obligation to purchase volumes of residue gas it is now obligated to purchase * * * and is willing to undertake to accomplish a resale of the volumes of residue gas which [CBN] is authorized to resell * * * in lieu of making delivery thereof to [CBN], and is willing to make certain payments to [CBN] with respect to the volumes of residue gas remaining from gas produced from its sour gas reserves to the extent of the volumes which [CBN] would * * * be authorized to sell to others. * * *.

The resulting agreement therefore merely transferred from plaintiff to Shamrock the right to sell for plaintiff part of the residue gas which plaintiff was required to purchase under the old contract (which volume plaintiff could resell under the old contract). Plaintiffs' remuneration was to be a share of Shamrock's new, higher, selling price. The transaction thus remained basically one of sale. Instead of CBN selling to others, Shamrock sold to others as CBN's agent. There was no change in status as between the parties. The respective interests of the parties to the contract were merely rearranged. Such a rearrangement surely could not transfer CBN's economic advantage to one of economic interest. CBN still lacked a property interest. The new contract did not give CBN a leasehold or fee in the land.[5] As we previously stated, the leasehold or fee rule may be disregarded in those instances where a rigid application would subvert Congressional intent. But

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[5] There was a conflict of opinion in the prior case as to whether the 1952 agreement contained a covenant running with the land. Such an encumbrance is usually specified with particularity. Such was the case in the pre-1952 agreement(s). The 1952 agreement, however, contained an ordinary clause relating to assignment. Such a material change in form indicates a material change in agreement between the parties, i.e., the 1952 agreement was not meant to contain a covenant running with the land.

we perceive no Congressional intent to allow a mere purchaser of oil, such as CBN, to gain an economic interest in oil in place.

Further, plaintiff's participation was not *essential* to the extraction of the gas. Shamrock could bring up and process the gas at will, without plaintiff's leave. As was stated in the dissenting opinion in the prior CBN case [164 Ct. Cl., at 558]:

> * * * Taxpayer's concern did not begin with the raw gas as it came from the well. Nor did that concern even commence with the manufacture of *residue* gas. Just as in the pre-1953 period, taxpayer's concern only began with the *sale* by Shamrock of the residue gas. Prior to that stage, plaintiff had no connection with the mineral. Under the express provisions of the 1952 agreement, Shamrock could use the gas, without accounting to plaintiff in any way, for specified ends of its own—including use for fuel for compression purposes, for processing and production purposes, and for manufacturing steam. Not until the moment of sale did any obligation to plaintiff arise or plaintiff have any concern with the gas.[9]
> * * *

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[9] The contract provided:

"4. There shall be no restriction nor limitation on Shamrock's right to remove liquid or liquefiable hydrocarbons or hydrogen sulphide from the gas produced from said reserves and there shall be no obligation, express or implied, on Shamrock's part to make payments to Columbia [plaintiff] on the proportionate part of said residue gas above specified, except as, if and when such residue gas is sold or used by Shamrock for purposes other than specified in subparagraphs (a), (b), (c) and (d) of Section 3 above: provided that if Shamrock should cease to process through its plant or plants the gas produced from its sour gas reserves, or any part thereof, and shall make sale thereof at the well or wells where produced, then such payments shall be applicable to the proportionate part of the raw gas volumes that may be sold by Shamrock." [164 Ct. Cl. p. 558—footnote 9.]

The element of essentiality has been thoroughly discussed in the first portion of this opinion. A further discussion of that principle is unnecessary. It suffices to say that no element of essentiality was present in plaintiff's relationship to the extraction of the gas. We hold that plaintiff does not possess the requisite interest in the gas in place to allow it to qualify for depletion allowance under the criteria established in *Southwest Exploration, supra,* or as later reinterpreted by this Court in *Tidewater, supra.* The *Tidewater* approach and reasoning changed the legal climate in this area to such a degree as to dictate the present result. The rigidity of collateral estoppel cannot apply in this instance.

Plaintiff's motion for summary judgment is denied, while defendant's cross-motion for summary judgment is granted. The petition is dismissed, according to the stipulation of the parties and this opinion.

LARAMORE, *Judge,* dissenting:

I respectfully dissent. *Tidewater Oil Company* v. *United States,* relied upon by the majority as showing a change in the legal climate, arose under a different contract and involved different facts. The facts in this case are in all respects identical to the facts in the prior *CBN Corporation* case and only encompass different tax years. I think the decision in *Tidewater* has not effected a sufficient change in the legal climate to warrant our departure from the doctrine of collateral estoppel. I would, therefore, permit recovery by plaintiff.

COWEN, *Chief Judge,* joins in the foregoing dissent.

APPENDIX B

Statutes and Regulations Involved

Internal Revenue Code of 1954:

SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.

(a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under regulations prescribed by the Secretary or his delegate. For purposes of this part, the term "mines" includes deposits of waste or residue, the extraction of ores or minerals from which is treated as mining under section 613(c). In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this section for subsequent taxable years shall be based on such revised estimate.

* * *

(26 U.S.C. Sec. 611.)

SEC. 613. PERCENTAGE DEPLETION.

(a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in subsection (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 percent of the taxpayer's taxable income from the property (computed without allowance for depletion). In no case shall the allowance for depletion under

section 611 be less than it would be if computed without reference to this section.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ per cent—oil and gas wells

* * *

(26 U.S.C. Sec. 613.)

Treasury Regulations on Income Tax (1954 Code):

SEC. 1.611-1 ALLOWANCE OF DEDUCTION FOR DEPLETION.

* * *

(b) *Economic interest.*—(1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possess[es] a mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

* * *

(26 C.F.R., Sec. 1.611-1.)

APPENDIX C

Opinion of the United States Court of Claims in *CBN Corporation* v. *United States*, 328 F.2d 316 (1964)

—o—

CBN Corporation (Formerly Columbian Carbon Company),

v.

The United States.

No. 243-59

United States Court of Claims

Feb. 14, 1964

—o—

Before Jones, *Chief Judge*, and Whitaker, Laramore, Durfee and Davis, *Judges*.

Jones, *Chief Judge*.

The plaintiff, the CBN Corporation (formerely Columbian Carbon Company), sues for an alleged overpayment of Federal income taxes which it claims were improperly collected by the defendant for the tax year 1953.

The ultimate issue is whether plaintiff had a sufficient economic interest in certain natural gas in place in Moore County, Texas, during the tax year 1953, under a contract hereafter described, to entitle it to participate in the depletion allowance for income tax purposes.

The issue is governed by sections 23(m) and 114(b)(3) of the Internal Revenue Code of 1939 (26 U.S.C., 1952

ed.).[1] These sections provide, in the case of oil and gas wells, a depletion allowance of 27½ percent of the gross income from the property during the taxable year.

Treasury Regulations 118[2] issued pursuant to the Code stipulates that the owner of an economic interest in

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[1] Pertinent parts of the two sections are as follows:

"§ 23. Deductions from gross income.

"In computing net income there shall be allowed as deductions:

* * *

"(m) Depletion.

"In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

"For percentage depletion allowable under this subsection, see section 114(b) (3) and (4).

* * *

"§ 114. Basis for depreciation and depletion.

* * *

"Basis for depletion.

* * *

"(3) Percentage depletion for oil and gas wells.

"In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph."

[2] Pertinent parts of Treasury Regulations 118 are as follows:

"§ 39.23(m)-1. Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.—

"(a) Section 23(m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for

mineral deposits shall be allowed an annual depletion deduction, and states that:

> "An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital."

The plaintiff reported an income tax liability for the year 1953 in the sum of $3,921,707.66 and paid this amount in installments during the year 1954. On March 28, 1957, the District Director, Internal Revenue Service notified plaintiff that an additional assessment for the year 1953 had been recommended in the sum of $115,574,37, plus

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depletion and for depreciation of improvements. Section 114 prescribes the bases upon which depreciation and depletion are to be allowed.

"(b) Under such provisions, the owner of an economic interest in mineral deposits or standing timber is allowed annual depletion deductions. * * *. An economic interest is possessed in every case in which the taxpayer has acquired, by investment, any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the severance and sale of the mineral or timber, to which he must look for a return of his capital. * * *

* * *

"(i) The property, as used in section 114(b) (2), (3) and (4) and §§ 39.23(m)-1 to 39.23(m)-19, inclusive, means the interest owned by the taxpayer in any mineral property. The taxpayer's interest in each separate mineral property is a separate 'property'; but, where two or more mineral properties are included in a single tract or parcel of land, the taxpayer's interest in such mineral properties may be considered to be a single 'property,' provided such treatment is consistently followed."

interest. That additional amount was assessed by the Commissioner of Internal Revenue and paid by the plaintiff.

The plaintiff filed a timely claim for a refund in the amount of $46,320.60 or such larger amount as might be legally refundable, on the ground that the Commissioner had erroneously disallowed a deduction for percentage depletion on royalty payments to the plaintiff by the Shamrock Oil and Gas Corporation (hereafter referred to as "Shamrock").

Notice of disallowance of the claim was issued in May 1959.

The claim for depletion allowance was based on a contract made in 1952, which became effective January 1, 1953, but for a clear understanding of that contract it is helpful to trace the dealings between the plaintiff and Shamrock which began in 1935.

Natural gas is ordinarily composed of hydrocarbons—hydrogen and carbon. There are a number of different combinations of carbon and hydrogen—named or classified on the basis of the relative proportions of the two main ingredients in the mixture.

When the natural gas reaches the surface some of the hydrocarbons are in liquid form and others are liquefiable.

Shamrock operated a plant called the McKee Plant in Moore County where the liquid or liquefiable hydrocarbons were extracted or separated from the lighter hydrocarbons. After such removal, about 95 percent of the original or raw gas remained. This remaining 95 percent is sometimes called residue gas. This remainder was not altered in individual physical or chemical characteristics by the process of extraction.

It will be noted that the statute provides that in the case of oil and gas wells the allowance for depletion "shall be 27½ per centum of the gross income from the property during the taxable year," excluding certain items of ex-

pense incurred by taxpayer. The allowance may be and frequently is divided among many different owners of economic interests in the property in question. The total allowance cannot exceed 27½ percent of the gross income. But that amount is allowed if claimed by those entitled to such deduction.

Usually the lessee pays those having economic interests on the basis of an aggregate of one-eighth of the market price of the oil or gas. The lease usually provides that the lessee may purchase the product but must account for the market price whether sold at the mouth of the well or purchased by the lessee or sold in the open market.

The sequence of events out of which the instant issue arises began in 1935. Shamrock was then engaged, *inter alia*, in the production of natural gas from lands owned or leased by that company in Moore County, Texas. The Western Carbon Company (hereafter referred to as "Western") at that time was engaged in the manufacture of carbon black by a process which burned vast quantities of natural gas.

An agreement was made between the two companies by the terms of which Western agreed to construct a plant for the manufacture of carbon black with a capacity for utilizing a minimum of 30,000,000 cubic feet of gas per day. The agreement also provided that Shamrock (referred to in the agreement as "Seller") should sell to Western (referred to in the agreement as "Buyer"), and the latter would purchase from Shamrock a daily minimum of 30,000,000 cubic feet of residue gas, i.e., natural gas from which the liquid and liquefiable hydrocarbons had been removed by Shamrock.

Pertinent terms of the agreement are set out in finding 12(b). The Buyer was given the right to cease burning the gas at any time, in which event the Buyer could resell to other purchasers. In the latter event different terms of

paying Shamrock for the gas were provided. The apparent reason for the provision was the fact that in the production of carbon black the burning of more than 1,000 cubic feet of gas was required to produce a small quantity of carbon black. There was a continuing threat of legislation to prevent such tremendous use of a natural resource to produce so small an amount of carbon black, even though the latter was a valuable product.

A similar agreement was entered into on the same date, October 1, 1935, between Shamrock and the Reliance Carbon Company, Inc., the respective parties being referred to as "Seller" and "Buyer."

A subsidiary agreement, also dated the same day, gave both Western and Reliance preferential rights in the purchase of gas made by Shamrock in 12,000 acres in Moore County. As a safeguard, the Buyer was given the "right at any time to cease burning all or any part of the gas it has been burning, and resell for other purposes said gas," at a different specified method of payment. (Findings 12 and 15.)

On January 2, 1936, Western assigned to plaintiff all rights in the agreements described above.

An amendatory agreement was entered into in 1937 between Shamrock and plaintiff, which was then operating the carbon black plant. The agreement increased the contracted plaintiff's minimum purchase of natural gas by 15,000,000 cubic feet per day.

The amendatory agreement further provided that "Buyer [plaintiff] shall have the first right hereunder in priority to all other uses or disposition of its natural gas made by Seller [Shamrock] in three thousand (3,000) acres of gas territory owned or controlled by Seller and located in Moore County, Texas, the gas from which is legally available for the manufacture of carbon black."

The agreement further provided that the plaintiff would add additional units to its carbon black plant, which it later did. The prior right to purchase and to receive gas was increased in 1946 by 3,250 acres. This later agreement also provided that Seller would desulphurize all gas to be resold. It also provided for a somewhat different method of paying Shamrock for the gas. Other minor amendments were entered into in 1947, 1949, and 1951. The material change in these agreements was the following:

> " * * * [T]he aggregate volumes of residue gas which Buyer [plaintiff] has the prior right to purchase and which Seller [Shamrock] has the obligation to sell and deliver to Buyer * * * is the fractional part of the residue gas remaining (after being processed for the recovery of liquid hydrocarbons in either Seller's McKee plant or its recently acquired Sunray plant, located near Sunray, Moore County, Texas) from all of the sour gas reserves of Seller heretofore accepted by Buyer * * * represented by a fraction, the nominator [sic] of which is 12,250, and the denominator of which is 62,225 * * *. Said fractional part of said residue gas is hereinafter referred to as the 'dedicated reserves' of Buyer. It is agreed, however, if there shall be available from such dedicated reserves of Buyer in excess of forty million (40,000,000) cubic feet daily, averaged monthly, Buyer shall not be obligated to purchase in excess of forty million (40,000,000) cubic feet daily, but shall be privileged to purchase, by notifying Seller in writing of its desire to so purchase, the volumes attributable to the reserves of Buyer up to forty-two million (42,000,000) cubic feet daily when such volumes are available from such sources * * *." [Finding 21.]

All of these agreements and the amendments thereto were purchase contracts. The Buyer agreed to purchase and pay in one form or another for a minimum of 30 or more million cubic feet of gas per day, and the Seller agreed to give the plaintiff the prior right to purchase the available gas produced from certain designated reserves available after removal of the liquids and liquefiable hydrocarbons.[3] Under the amendatory provisions, the obligations were limited to fractional parts of the designated reserves.

Under all these contracts Shamrock had claimed and had been granted the full 27½ percent depletion deduction for all of the gas used in the contracts and the amendatory agreements. Plaintiff did not claim at any time any depletion allowance under these purchase agreements.

After September 11, 1951, Shamrock represented to the plaintiff that it desired to be free of the dedication to the plaintiff of its gas reserves in Moore County in order that Shamrock might be free to negotiate more favorable contracts with the Northern Natural Gas Company. In October it negotiated a contract with the latter company to be effective January 1, 1953, for the sale of gas, including gas from the acreage to which the plaintiff had been given the prior right of purchase. However, as will be noted in finding 21, that dedication had been by one of the amendments limited to a fractional part approximately one-fifth of the gas from the dedicated area.

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[3] The 1935 contract contained the following provision:

"* * * nothing herein contained shall prevent Seller from selling, trading or abandoning any lease or gas contract in the ordinary course of business, or of exchanging any part of its gas resources for other gas resources of substantially equal amount."

THE NEW CONTRACT

On November 19, 1952, Shamrock and the plaintiff entered into a contract that superseded the prior agreements between the parties. Pertinent parts of the new agreement are set out in finding 24.

This was an entirely different contract. It terminated the previous agreements. Under the new contract the plaintiff was no longer obligated to buy and Shamrock was no longer obligated to sell any gas to the plaintiff. Thereafter Shamrock was to sell or dispose of the gas.

As compensation, Shamrock agreed to pay plaintiff 6 cents per 1,000 cubic feet (Mcf) in connection with the sales of residue gas that were within the scope of the contract. The contract covered a fraction, the numerator of which was 9,000 and the denominator 62,625, of the reserves described in Schedule A attached to the contract. The contract covered the residue gas after the removal of all liquids or liquefiable hydrocarbons, and after certain other requirements named in the contract had been defined. Subject to these exceptions plaintiff was to be paid 6 cents per Mcf on the designated percentage of all gas produced, used, or sold from the designated properties. Plaintiff's right to be compensated was further safeguarded by the following stipulation:

> "4. * * * provided that if Shamrock should cease to process through its plant or plants the gas produced from its sour gas reserves, or any part thereof, and shall make sale thereof at the well or wells where produced, then such payments shall be applicable to the proportionate part of the raw gas volumes that may be sold by Shamrock." [Finding 24.]

Paragraph 9 of the contract stipulated that plaintiff would not be required to pay any portion of gross production or severance taxes levied prior to March 1, 1950. Plain-

tiff, however, agreed that it should be billed by Shamrock for its proportionate part of any increases after March 1, 1950, of gross production taxes, severance taxes or other excise taxes, and other taxes that might be thereafter levied. Plaintiff thereafter paid its proportionate share of increased production taxes, severance taxes, and other excise taxes levied upon or with respect to volumes of gas as specified in paragraph 9.

After the cancellation of the old agreements and entering into of the new contract, Shamrock did not claim any depletion allowance for the portion of the gross income from the residue of gas, use or sales that had been paid to the plaintiff. Plaintiff, after the 1952 contract, which became effective January 1, 1953, claimed a depletion allowance in reporting and paying its income for the year 1953. The deduction was disallowed, additional assessments were levied and collected, and plaintiff seeks a refund.

The question is: Did the plaintiff have an economic interest in the gas in place under the new contract which became effective January 1, 1953?

The plaintiff asserts that under the statute and regulations heretofore quoted and under the decisions of the various courts, it had an economic interest in the gas in place under the new contract. The defendant claims that plaintiff did not have such an interest.

We think plaintiff had such an economic interest. All of the previous agreements—the ones entered into in 1935 and all amendments thereto—were pure purchase agreements with varying terms but nevertheless the plaintiff was a buyer and Shamrock a seller of the residue gas up to a certain minimum from a designated acreage in Moore County, Texas.

Under the new contract the plaintiff was no longer a purchaser nor was it a user of natural gas. It was simply permitted to sit back and draw what was equivalent to roy-

alty payments on its designated percentage of all gas produced, used or sold from the acreage designated in the new contract.

Under the old contracts, plaintiff purchased and used and had the privilege of reselling all of the residue gas covered by the contracts. The plaintiff was nothing more than a purchaser with certain priority rights of purchase. Under the 1952 contract it was no longer a purchaser with the right to either use or resell the gas. In this respect the plaintiff was in the position of any holder of royalty interest in the proceeds of oil or gas production. Practically all lease contracts have a provision that the royalty holder or holders shall be paid usually one-eighth of the proceeds of the sale at the then market price of a pro rata part of any oil or gas that is produced and marketed.

Some of the royalty provisions stipulate that the owner or holder of the royalty is entitled to one-eighth of the oil or gas produced. However, the standard form provides that the lessee shall have the right to purchase the oil or gas in the pipeline or sell it in the open market, accounting to the royalty owner for his proportionate part of the sales or market price of the product. If the lessee sells or transfers the commodity to someone else for production and marketing he must account for the royalty for his proportion of the market price of the product at the time.

Likewise, if Shamrock removed and sold or used any of the gas covered by the contract it must account to the plaintiff for the payments. If it used the gas, it was required to account to plaintiff for the market price at the time. If Shamrock ceased to process the gas produced from the reserves and should make a sale at the well or wells where produced, the plaintiff was required to be paid for the proportionate part of the raw gas volumes sold by Shamrock. In fact on the occasion of explosion and fire that destroyed Shamrock's plant in Moore County, this is exactly the

course that was taken and plaintiff was paid on the specified basis until such time as the plant could be restored.

Thus, Shamrock could not remove for use or resale a single cubic foot of gas without paying plaintiff its designated percentage of the proceeds. It could not even sell the product at the well without accounting to the plaintiff for its payments.[4] The plaintiff could require Shamrock to keep the oil in place or make its payments. There was no other alternative. There was no way for either party to receive any funds unless Shamrock removed and used or sold the commodity itself. Even if Shamrock had sold or transferred all its holdings and lease contracts in Moore County to another producer while the product was still in the ground, the plaintiff's rights would follow and still be effective and plaintiff would be entitled to its payment either by the buyer, the transferee, or by whoever might remove the gas. In other words, it had an economic interest in the gas in place which remained through any of these changes.

It is not necessary that the holder of an economic interest have title to the property. This is made clear in the case of Commissioner v. Southwest Exploration Co.,

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[4] The 1952 contract ran with the land. In fact both contracts ran with the land. Any contract runs with the land if it affects the land, is in writing duly acknowledged and filed with the deed records. This is true in practically all the states. The provision is fashioned after the old English statute of frauds which was enacted to prevent oral contracts affecting and complicating land titles.

No doubt the reason for including the specific provision in the original contract was the fact that in that agreement Shamrock had the right to substitute other lands for those designated, provided they had equivalent productive quality. It was simply to make certain that such substitution would not affect plaintiff's purchase contract. No substitution was provided in the new contract. Plaintiff's interest was tied to the specific lands. Due to the cancellation, there was of course no obligation on the part of plaintiff to purchase any gas after January 1, 1953.

350 U.S. 308, 312, 314, 76 S. Ct. 395, 100 L. Ed. 347 (1956), where it states that:

> "* * * a taxpayer is entitled to depletion where he has: (1) 'acquired, by investment, any interest in the oil in place,' and (2) secured by legal relationship 'income derived from the extraction of the oil, to which he must look for a return of his capital.' [Palmer v. Bender] 287 U.S. [551], at 557 [53 S. Ct. 225, at 226, 77 L. Ed. 489]." [350 U.S. p. 314, 76 S. Ct. p. 312, 100 L. Ed. 347]

No particular form of the legal interest of a taxpayer is required in deciding whether the taxpayer has the necessary economic interest for purposes of the depletion allowance. See Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, 66 S. Ct. 861, 90 L. Ed. 1062 (1946), and cases therein cited, for a thorough discussion of the principles involved. As was stated in Southwest Exploration Co., supra, the depletion allowance in the Internal Revenue Code of 1939 is solely a matter of congressional grace and is limited to the 27½ percent of the gross income from the property after eliminating certain items paid by the taxpayer with respect to the property.

The fact is that a depletion allowance is not given to anyone until the product is taken from the ground. If an owner of a piece of land sells it outright he gets no depletion allowance because, in fact, there is no depletion. Until there is some separation and thus some exhaustion and and until that separated portion is marketed or sold in some form that produces income, there is no tax and in the nature of things there can be no deduction for depletion. Production and marketing, under standard oil and gas lease contracts, are as intimately linked as the law of demand and supply.

We quote from the case of Palmer v. Bender (1933), 287 U.S. 551, at pages 557-58, 53 S. Ct. 225 at pages 226-227, 77 L. Ed. 489, the following:

> "Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the leasing transaction, he has retained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production. Thus, we have recently held that the lessor is entitled to a depletion allowance on bonus and royalties, although by the local law ownership of the minerals, in place, passed from the lessor upon the execution of the lease."

The case of Helvering v. Bankline Oil Co., 303 U.S. 362, 58 S. Ct. 616, 82 L. Ed. 897 (1938), which both parties cite, makes the distinction between economic advantage and economic interest. It recognizes that the language of the statute is broad enough to cover any form of legal relationship, and cites Palmer v. Bender, supra. It distinguishes the two cases on the ground that the respondents's contract in the Bankline case was merely for installing and maintaining the necessary pipelines through which the producer agreed to deliver the natural gas produced at the well and that respondent should extract the gasoline therefrom and pay to the producer 33⅓ percent of the total gross proceeds derived from the sale of the gasoline or wet gas, and that the taxpayers was still a processor paying for what it received at the well's mouth and therefore had no capital investment. In other words, that was simply another purchase contract and the taxpayer was found to have no interest as a processor of natural gas

where it only contracted to buy gas after severance from the ground.[5]

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[5] We have examined all the cases cited by both parties, as well as some other decisions, and while there is some overlapping and indeed some confusion, this clear dividing line is recognized by all of them. This was true in Scofield v. La Gloria Oil and Gas Co., 5 Cir., 268 F.2d 699 (1959), and in Parsons, et al. v. Smith, 359 U.S. 215, 79 S. Ct. 656, 3 L. Ed. 2d 747 (1959), as well as in the other cases which defendant discusses.

The Palmer v. Bender case, supra, makes it clear that the right to depletion allowance does not depend on ownership, or any other particular form of legal interest in the contract.

In Commissioner v. Sonthwest Exploration Company, supra, which involved slant or whipstock drilling, the owner of the upland site had no title or ownership in the underwater oil. It simply contracted as an upland owner to furnish the site for the drilling equipment and machinery and was to receive a percentage of the net profits. The drilling leaseholder claimed the entire 27½ per centum of the depletion allowance, but the Supreme Court held that the upland owner who merely owned the site was entitled to its proportion of the depletion and the leaseholder to the balance. The Court does mention in Southwest that the site furnished was essential to the drilling contract, but this was only one of the elements mentioned by the Supreme Court. We have seen no case that holds that a party must be essential to a drilling contract in order to have an economic interest. There are many cases where the holder of an economic interest was not essential to a drilling contract, except in the sense that no minerals could be marketed without payment to the holder of the interest. It would be futile to drill if the product could not be sold. Neither in the Southwest case nor in the case at bar. could the minerals be removed without compensating the contract holder of an interest in the proceeds of any minerals produced or removed.

The case of Elm Development Company v. Commissioner, 4 Cir., 315 F.2d 488 (1963), affecting coal, deals with the same principle involved here, and holds that an independent operator who contracts with the lessee to mine coal at a certain adjustable price per ton has an economic interest entitled to depletion deduction. It contains an excellent discussion of the subject and distinguishes that case from Parsons v. Smith, supra.

None of the other cases cited by either party materially changes this over-all picture.

The defendant undertakes to cite this authority for the claim that in the instant case the taxpayer had made no capital investment, but the record clearly shows the facts to be otherwise. The record shows that the price and demand for natural gas had increased. The plaintiff under the old agreements had the right to purchase this gas in making carbon black and resell the excess. It had priority rights in the purchase and the use of a specified minimum of 40,000,000 cubic feet of gas per day. While apparently the demand for gas in vast quantities for the manufacture of carbon black was probably not as great—whether on account of new processes for manufacture of carbon black or the enactment or threat of enactment of future conservation measures and restrictions does not appear from the record—the general sale of natural gas was greatly increasing and the plaintiff had the privilege of reselling the gas in a market that was rapidly expanding.

Plaintiff traded all these advantages for a new contract that simply gave it an assured right to participate on a definite basis of a definite percentage of all the residue gas produced by Shamrock during the life of the field. This was certainly the cancellation and surrender of a valuable right and was full and adequate consideration for an economic interest in the gas in place. This is especially true since neither Shamrock nor any assignee could produce or extract a single cubic foot of natural gas nor secure one cent of revenue for itself without accounting to the plaintiff for the payment of its proportionate share of the gross income.

The 1952 contract was an arm's length transaction in which plaintiff released its absolute right to purchase a portion of Shamrock's reserve and received in consideration the equivalent of an overriding royalty. This was certainly a substantial investment. Plaintiff's right to the payment for the gas sold by Shamrock was noncancel-

lable and an indefeasible right to the payment so long as production existed.

Plaintiff's interest in the gas was as depletable under the new contract as was the interest of Shamrock. Both oil and gas are depletable products; sometimes very rapidly and sometimes before the cost of drilling is paid for. When the product is exhausted all interests of either party are gone. Both Shamrock and plaintiff had an economic interest under the new contract in the gas in place. The attorneys for both Shamrock and plaintiff evidently proceeded on the belief that under the purchase contracts and amendments thereto made in 1935 and subsequent years prior to the 1952 contract, Shamrock was entitled to the complete 27½ percent depletion deduction on the entire gross income, and the full 27½ percent was claimed by Shamrock and allowed by the Internal Revenue Service. In any event, the question of whether plaintiff could have asked for a part of the depletion allowance under the old contract is not involved here and is immaterial since it has no bearing on the question of whether plaintiff has an economic interest under the new contract.[6]

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[6] We further summarize our position as follows:

1. See footnote 4.

2. By the terms of the November 19, 1952 contract, the earlier contracts were terminated and were to have "no further force and effect (after January 1, 1953) except as to final accounting." Whatever may have been their terms they were cancelled as of January 1, 1953. For this reason, the terms of the 1935 contract have no bearing on the 1952 contracts. Any claim for depletion deduction that plaintiff might possibly have made under the old contract has long since been barred by limitations. However, since that contract has been under discussion, we would like to state why we conclude that plaintiff never had any depletion rights under the former contracts.

3. The 1935 contract was a purchase contract, that is, plaintiff had a priority right to purchase a minimum amount of gas at a specified price. The plaintiff is termed "Buyer" and Sham-

Under the new contract both Shamrock and plaintiff proceeded on the basis that each was entitled to its division of the 27½ percent. Therefore, after 1952 Shamrock claimed and was allowed only its proportionate part of

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rock "Seller." The Buyer could burn or resell the excess gas. Should the area designated prove insufficient to supply plaintiff with enough gas to meet its needs, the Seller would not be responsible for the shortage but plaintiff might purchase the balance of its needs elsewhere.

4. The cases generally hold that a purchaser of gas after it is produced does not have a depletable interest. There are literally thousands of such purchasers who, if their purchase of marketable gas entitled them to depletion deduction, would be making claims, thus vastly complicating the present problems. Hence, the necessity for drawing a line.

5. Under the terms of the 1952 contract, plaintiff was no longer a Buyer, and Shamrock was no longer a Seller to plaintiff. Shamrock, which had been the Seller in the old contracts, now took over the complete production and marketing of the gas. The former Buyer had no part in the marketing. It only had the right to 6 cents per thousand cubic feet of any gas that might be produced and either used or marketed by any one. Shamrock agreed to take over from plaintiff the resale of any gas which plaintiff was obligated to purchase under the terms of the old contracts. This applied merely to any gas plaintiff was obligated to purchase under the old contracts up to the time of the effective date of the new contract, i.e., January 1, 1953.

6. By article 5 of the earlier contracts, the Seller was not only to produce but was required to build a 22-inch pipeline and deliver the gas to purchaser's plant. By section 14 of the original contract, that part of the purchase price of gas which Seller was to receive in carbon black is classed as royalty to Seller.

7. While the 1935 contract was binding on both parties, their successors and assigns, the limitations on the numerous rights of the respective parties would also bind the assigns. The Buyer was not required to purchase all the gas produced on the property in question. There was a minimum and a maximum amount of gas the Buyer was required to purchase.

the allowable deduction and plaintiff claimed only its percentage of the same deduction, the denial of which is the basis of this action.

There is no doubt that someone was entitled to the entire 27½ percent. When asked in oral argument how it came to pass that only a part of the statutory 27½ percent was allowed for 1953, the response of defendant's counsel was that Shamrock probably made a mistake in not claiming the balance. At any rate, someone is entitled to the exhaustion or depletion allowance of that portion of the gross income which is represented by plaintiff's part of the gross income. It seems manifest from the record that plaintiff had an economic interest in the gas in place and is entitled to a depletion deduction with respect to its income from that interest. We so find.

The amount of recovery will be determined pursuant to Rule 38(c) of the rules of this court.

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8. By the terms of the new contract, the former Buyer was no longer in any sense a purchaser. Shamrock was both producer and Seller. Shamrock was simply required to pay a royalty of 6 cents per thousand cubic feet of gas which Shamrock should produce and market. Plaintiff was required to do nothing. However, neither Shamrock nor its successors could produce and dispose of a single cubic foot of gas without paying plaintiff a royalty. This certainly gave plaintiff an economic interest in the gas in place.

9. By article 10 of the 1952 contract, plaintiff's rights could not be transferred until Shamrock had been furnished with the original instrument of transfer. By article 11, it was stipulated that "This Agreement (1952 contract) shall continue so long as gas is produced from any gas well or wells" described in the contract. By article 12, the contract was made binding on the parties, their successors and assigns. These provisions are usual in any royalty contract.

10. The cases uniformly hold that legal title is not required, but only an economic interest in the minerals in place, and that no particular form is necessary in preserving that interest.

DAVIS, Judge (dissenting):

The court holds, and plaintiff expressly admits in its briefs, that prior to the 1952 contract plaintiff had no depletable interest in the natural gas produced by and purchased from Shamrock. At the oral argument, after questioning from the bench, plaintiff ultimately withdrew from this concession, but its original position was clearly right. Under the 1935 agreement (as supplemented), plaintiff's predecessor had no "economic interest" in the gas in place but only the "economic advantage" possessed by a purchaser of the gas who has obtained favorable terms from the seller. Helvering v. Bankline Oil Co., 303 U.S. 362, 58 S. Ct. 616, 82 L. Ed. 897 (1938), authoritatively ruled that a taxpayer which purchased gas from the producer, and then processed it (by removing the heavier hydrocarbons), was not entitled to depletion. For the period before 1953, this holding blankets plaintiff *a fortiori;* plaintiff was further removed than the purchaser in Bankline from the gas in place since it purchased the gas from Shamrock *after* the latter had extracted the gas and removed the heavier hydrocarbons. The fact that in this case the agreement was for the life of the seller's resources in Moore County does not distinguish Bankline; there, one type of contract called for the purchase of all natural gas produced at a given well (id., 303 U.S. at 365, 58 S. Ct. 616, 82 L. Ed. 897). See, also, Scofield v. La Gloria Oil & Gas Co., 268 F.2d 699 (C.A. 5, 1959).

I can discern no transformation, via the 1952 contract, from a mere economic advantage to an economic interest in the gas in place. That new contract did not purport to grant plaintiff any property interest—*e.g.*, leasehold or fee—either in the land from which Shamrock drew its gas

or in the gas itself.[7] No other change in status, as between the parties, is spelled out in the phrasing of the agreement. Rather, the paragraphs of the preamble (together with the circumstances surrounding the new pact) indicate that the parties simply desired to rearrange the terms of purchase and sale for their mutual advantage. Plaintiff wished to shut down its carbon black plant and to resell all of the gas purchased from Shamrock; the latter wished to sell the gas more profitably to another company; both parties "concluded that it would be more economical and convenient to arrange for the resale of the aforesaid volumes to be made by Shamrock in its own name and on its responsibility as between the seller and purchaser of such gas."[8] The resulting agreement merely transferred from

[7] The 1952 agreement contains no provision declaring it a covenant running with the land, but merely the ordinary clause stating that the contract shall be binding and inure to the parties and their successors and assigns. In contrast, the earlier agreement contained, in addition to the normal clause relating to assignment, another clause specifically agreeing "that the provisions of this agreement * * * shall be deemed to be covenants running with the respective lands, leases," etc., and also covenanting that the "parties * * * will not dispose of any of same in bulk, or in such material part as to disable them from performing their obligations hereunder without causing the party to whom such property shall be transferred, together with its successors and assigns, to assume and be bound by the terms hereof."

[8] The preamble to the 1952 contract discloses (in its fourth paragraph) that plaintiff desires to shut down its carbon black plant and "desires to effect a *resale* of the volumes of gas it is authorized to resell under the terms and provisions of the aforesaid contracts (i.e., the pre-1952 contracts)." (Emphasis added.) In the fifth paragraph of the preamble, it is pointed out that any purchaser of such residue gas would have to receive it from Shamrock and would likewise have to deal with Shamrock on various matters (e.g., pressure, deliveries, etc.); the preamble then goes on to say that "the parties hereto, having considered such matters, have concluded that it would be more economical and convenient to arrange for the

plaintiff to Shamrock, its vendor, the right to sell for it the part of the residue gas which it was required under the old contract to purchase and which it could resell; plaintiff's compensation was to be a share of Shamrock's new (and higher) selling price. The transaction, though more complex, remained at bottom one of sale and purchase. Plaintiff gained no property interest of any kind in the land or minerals.

Aside from Commissioner v. Southwest Exploration Co., 350 U.S. 308, 76 S. Ct. 395, 100 L. Ed. 347 (1956), no Supreme Court decision has allowed depletion to a taxpayer who did not have either a fee or leasehold interest in the oil-producing property itself. Taxpayer equates itself with the upland owners in Southwest Exploration whose land was essential to drilling operations and whose contribution of that essential upland "was an investment in the oil in place sufficient to establish their economic interest" (id. 350 U.S. at 316, 76 S. Ct. at 399, 100 L. Ed. 347). The investment here, it is argued, was the former contractual right to obtain residue gas from Shamrock; that contribution, it is also said, is essential to Shamrock's

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resale of the aforesaid volumes to be made by Shamrock in its own name and on its responsibility as between the seller and the purchaser of such gas and that an accounting between the parties hereto with respect to such *resale* volumes be made on a basis mutually satisfactory in lieu of the accounting between the parties required under the terms of the aforesaid contracts in the event a *resale* of such volumes to another purchaser should be accomplished by Columbian." (Emphasis added.) The sixth paragraph of the preamble states that Shamrock "is willing to undertake to accomplish a *resale* of the volumes of residue gas which Columbian is authorized to *resell* under the provisions of the aforesaid contracts in lieu of making delivery thereof to Columbian, and is willing to make certain payments to Columbian with respect to the volumes of residue gas remaining from gas produced from its sour gas reserves to the extent of the volumes which Columbian would, except for this contract, be authorized to sell to others." (Emphasis added.)

producing activities. The opinion in Southwest Exploration, however, cautions that the Supreme Court was not taking a drastic step away from the prior doctrine (id. 350 U.S. at 316-317, 76 S. Ct. at 399-400, 100 L. Ed. 347). In my view the theory of that decision cannot properly be applied to plaintiff's case.

The upland in Southwest Exploration was physically essential (under California law) "to the drilling for and extraction of oil" (350 U.S. at 317, 76 S. Ct. at 400, 100 L. Ed. 347); but no interest of plaintiff's, contractual or proprietary, was essential to the physical process of extraction and production of gas by Shamrock. That company could bring up and process the gas without trenching on any of taxpayer's rights and without its leave. Taxpayer's concern did not begin with the raw gas as it came from the well. Nor did that concern even commence with the manufacture of *residue* gas. Just as in the pre-1953 period, taxpayer's concern only began with the *sale* by Shamrock of the residue gas. Prior to that stage, plaintiff had no connection with the mineral. Under the express provisions of the 1952 agreement, Shamrock could use the gas, without accounting to plaintiff in any way, for specified ends of its own—including use for fuel for compression purposes, for processing and production purposes, and for manufacturing steam. Not until the moment of sale did any obligation to plaintiff arise or plaintiff have any concern with the gas.[9] This was not an interest in the gas *in place.*

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[9] The contract provided:

"4. There shall be no restriction nor limitation on Shamrock's right to remove liquid or liquefiable hydrocarbons or hydrogen sulphide from the gas produced from said reserves and there shall be no obligation, express or implied, on Shamrock's part to make payments to Columbian [plaintiff] on this proportionate part of said residue gas above specified, except as, if and when such residue gas is sold or used by Shamrock for purposes other than specified in subparagraphs (a), (b), (c) and (d) of

The court, in holding otherwise, stresses the fact that there was no way for either party to receive any funds unless Shamrock removed and used or sold the commodity itself. But the test of a depletable interest is not the mere participation of the taxpayer in the realization of gain from the mineral. The regulations provide (Treas. Reg. 118, § 39.23(m)-1(b)) that "an agreement between the owner of an economic interest [*i.e.*, Shamrock] and another entitling the latter to purchase the product upon production or to share in the net income derived from the interest of such owner does not convey a depletable economic interest." The Bankline decision, supra, similarly held against a depletable interest where the contractor had the right to purchase all the gas from the well. See, also, Parsons v. Smith, 359 U.S. 215, 79 S. Ct. 656, 3 L. Ed. 2d 747 (1959); Scofield v. La Gloria Oil & Gas Co., supra. In those situations it was just as true as here that neither party—landowner or contractor—could receive any funds unless the owner removed and sold the gas. The same was true under plaintiff's pre-1952 agreement. As in that instance, this factor is insufficient to give plaintiff an economic interest in the gas *in place*.[10]

I am concerned, too, that the rearrangement of plaintiff's contract with Shamrock should be considered the

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Section 3 above; provided that if Shamrock should cease to process through its plant or plants the gas produced from its sour gas reserves, or any part thereof, and shall make sale thereof at the well or wells where produced, then such payments shall be applicable to the proportionate part of the raw gas volumes that may be sold by Shamrock."

[10] In Anderson v. Helvering, 310 U.S. 404, 409, 60 S. Ct. 952, 84 L. Ed. 1277 (1940), the Court said:

"A share in the net profits derived from development and operation * * * does not entitle the holder of such interest to a depletion allowance even though continued production is essential to the realization of such profits."

equivalent of a capital investment, in 1952, in the mineral. If such an investment is deemed to have been made here, it would appear relatively easy for a contractor with a mere "economic advantage" to obtain a depletable "economic interest" by a reshuffling of the contractual terms—and without the grant of a recognizable property interest in the land or mineral. The Supreme Court seems to have had a more conventional and substantial type of "investment" in mind. See Parsons v. Smith, supra; Commissioner v. Southwest Exploration Co., supra.

For these reasons, I would grant judgment for the defendant.

APPENDIX D

Opinion of the Court of Claims in *Tidewater Oil Co.* v. *United States*

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TIDEWATER OIL COMPANY,

v.

THE UNITED STATES.

No. 30-61

UNITED STATES COURT OF CLAIMS

Dec. 11, 1964

REHEARING DENIED MARCH 12, 1965.

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Before COWEN, Chief Judge, and LARAMORE, DURFEE, DAVIS and COLLINS, Judges.

LARAMORE, *Judge.*

This is a suit for refund of Federal income taxes for the year 1952 in which the ultimate question presented is whether the amounts paid by taxpayer to transferors of "oil allowables" constitute royalties so that, under section 114(b)(3)[1] of the Internal Revenue Code of 1939, such

[1] Section 114 provides in pertinent part as follows:

"§ 114. Basis for depreciation and depletion. * * *

"(b) Basis for Depletion.—* * *

"(3) Percentage Depletion for Oil and Gas Wells. In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. * * *."

payments must be excluded from gross income before computing taxpayer's depletion allowance. The answer to this question depends on whether the assignors of the allowables had a depletable "economic interest" in the oil in place with respect to the oil produced under these allowables. Taxpayer asserts it is the only one entitled to claim depletion. The government urges that the transferors of the allowables have the requisite "economic interest" to entitle them to share in the depletion deduction allowed by section 23(m)[2] of the Internal Revenue Code of 1939. It is not disputed that either the taxpayer or the transferors (but not both) is entitled to claim depletion with respect to the amounts paid to the transferors for these allowables.

During the year 1952, Tidewater was the owner and operator of various oil and gas leases located in the East Texas Oil Field. That Field is under the control and supervision of the Texas Railroad Commission, which exercises authority over oil and gas drilling and production operations in the State of Texas. The Railroad Commission makes monthly determinations of the number of barrels of oil which can be produced from each well. Each well in the Field is assigned an allowable in barrels per

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[2] Section 23 provides in pertinent part as follows:

"§ 23. Deductions From Gross Income. In computing net income there shall be allowed as deductions: * * *.

"(m) *Depletion.* In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *."

For percentage depletion allowable under this subsection, see section 114(b), (3) and (4).

producing day by the Railroad Commission. In addition to the proration of the number of allowable barrels to be produced per well, the Railroad Commission also establishes the number of days each month during which each well can produce. The amount so fixed is referred to as the "allowable" for each well.

The record discloses that the East Texas Oil Field is about 42 miles long (north to south) and 4 to 8 miles wide (east to west).[3] The Field has been described as a large pool or reservoir of oil, having a natural water drive from west to east produced by encroaching subterraneal water which bounds the field on the west. Bottom-hole pressure, which forces oil to the surface through the wells drilled in the field, is created and maintained by this natural water movement. The extent and ease of production of oil are determined in the main by the water-oil contact. As oil is withdrawn, water moves from the west to replace it and sweeps the oil along in the process.

As early as 1938, it was realized that withdrawal of salt water from the field must be curtailed both to prevent a drop in bottom-hole pressure (which would reduce total recoverable oil reserves and increase production costs) and to prevent pollution of fresh water supplies. Two methods of achieving this result were developed. The first was to encourage reinjection of salt water into the field;[4] the second was to encourage owners and operators to close wells producing excessive amounts of salt water and transfer production to other wells in the field which

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[3] See *Burford* v. *Sun Oil Co.*, 319 U.S. 315, 63 S. Ct. 1098, 87 L. Ed. 1424 (1943) for an extensive description of the East Texas Oil Field.

[4] An operator who reinjected salt water that had been produced, or who engaged someone to do it for him, was given an additional oil allowable for reinjecting salt water into the reservoir.

were not producing salt water.[5] These transferable rights to produce are referred to as "salt-water shut-in allowables."

It is the second method which gives rise to the problem involved in this case. By order dated July 10, 1947, the Railroad Commission permitted the operator of any well in the field producing 100 or more barrels of water a day, to shut in that well and transfer its "allowable" to another well or wells producing less than 25 percent water. The transferred allowable would be added to the transferee's existing allowable to increase production from the transferee's well or wells to the extent of the allowable transferred. After the transferred allowable ceased, the transferor operator could reopen the shut-in well and resume production under the applicable Railroad Commission Order if it chose to do so.

Taxpayer acquired from other unrelated operators a number of such salt water shut-in allowables, and during the year 1952 a portion of taxpayer's production of oil from its leases in the East Texas Oil Field was under these acquired allowables. Under the typical assignment of a shut-in allowable,[6] the assignor sold all of its rights to its allowable on specific wells and agreed that all of the oil produced by the assignee under the allowable should be property of said assignee. The assignee (taxpayer) agreed to pay assignor a stated price per barrel, which varied with the posted sales price "for each and every barrel of such transferred allowable which assignee produces * * *."

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[5] An operator who closed down a well producing more than 100 barrels of salt water a day was permitted, beginning in 1942, to transfer his allowable to other wells on the same lease, and later was permitted, beginning in 1947, to transfer the allowable to other operators in the East Texas Oil Field.

[6] See finding 11 where a typical assignment of a shut-in allowable is set out. [Finding 11 set out in Appendix.]

In its tax return for 1952, taxpayer did not claim depletion on the amounts paid to assignors; this amount was excluded from gross income in determining the base for depletion. Taxpayer later filed a timely claim for refund, asserting it was entitled to claim depletion on this amount. That claim was denied, and this suit followed.

As stated earlier, the decision in the case at bar turns on the question whether the transferors of the allowables have the requisite "economic interest" to entitle them to share in the depletion deduction allowed by section 23(m) of the 1939 Code. The "economic interest" concept, which is used in defining the intended beneficiaries of percentage depletion, was originally formulated by the Supreme Court in Palmer v. Bender, 287 U.S. 551, 53 S. Ct. 225, 77 L. Ed. 489 (1933). The Court, aware of the necessity of creating a uniform law of taxation independent of the complexities of local law, freed the right to depletion allowance from "any special form of legal interest in the oil well" and reasoned that

> "[t]he language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital." [287 U.S. at 557, 53 S. Ct. at 226]

As pointed out recently in Commissioner v. Southwest Exploration Co., 350 U.S. 308, 76 S. Ct. 395, 100 L. Ed. 347 (1956), the two requisites of an economic interest established by Palmer v. Bender, supra, are (1) that the taxpayer must have acquired by investment an interest in the mineral in place, and (2) that he look to the extraction and sale of the mineral for the return of this investment. Since Palmer v. Bender, quite naturally the battles in this area of tax law

have been fought over whether there was an interest in the oil in place of the proper sort and whether the source of the return of the taxpayer's capital was the extraction and sale of mineral.

The major factor seriously in dispute between the parties, in the case at bar, involves the first criterion—an interest in the oil in place.[7] The government espouses two theories—either one, it contends, provides the transferors of the allowables the requisite interest in the oil in place so as to entitle them to claim depletion on the amounts received from taxpayer for each barrel of oil produced pursuant to the transferred allowables. One view is based on the physical and geologic characteristics of the East Texas Oil Field. The government argues that since the Field is a common pool or reservoir of oil, when taxpayer was permitted to withdraw a greater quantity of oil made possible through the acquisition of the allowables, it in effect was withdrawing the oil under the transferors' closed wells. From this the government concludes that the economic interest in the oil in place under the closed wells which the transferors have, is sufficient to entitle them to depletion. In support of this argument the government

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[7] Taxpayer, during oral argument, urged that the transferors did not meet the second requirement of "an economic interest." This second factor has been interpreted to mean that the owner of the interest must look *solely* to the extraction of oil for a return of his capital, and depletion has been denied where the payments were not dependent on production. *Helvering* v. *Elbe Oil Land Development Co.*, 303 U.S. 372, 58 S. Ct. 621, 82 L. Ed 904 (1938). Taxpayer argues that it had to pay the transferors regardless of whether or not it produced oil under the "allowables." It cites *P. G. Lake, Inc.* v. *Commissioner*, 24 T.C. 1016 (1955) in support of its contention. Although the Tax Court based its decision on the testimony of an official of the producing company, a reading of the assignment contract before us indicates that the payments to the transferors were to be based solely on production.

points out that the Railroad Commission based the amount of the "salt-water shut-in allowable" which could be transferred according to a "decline curve" which was designed to approximate the oil which could have been produced from the closed well, had it remained in operation. On the other hand, taxpayer points out that there is nothing in the record to suggest that the oil under the transferors' leases was depleted, but on the contrary the Railroad Commission's Order specifically provided for the resumption of production by the transferors, after the expiration of the "allowable." Taxpayer also points out that it is a common occurrence in the East Texas Oil Field, that within a short distance from an extremely productive well, no oil is found. Moreover, the shut-in wells were scattered over most of the Field and are not limited to one region, as would be required by the government's theory. All these factors, taxpayer argues, contradict the government's conception that the East Texas Oil Field is a single large underlying pool of oil being tapped with equal facility by all the wells in the Field.

The general plan which the Railroad Commission attempted to carry out by the use of the "decline curve" in determining the amount of the "allowable" for each well, seems, at first blush, to support the government's position. However, for the "decline curve" to carry out its intended result, i.e., that at the expiration of the "allowable" the oil under the transferor's well would be depleted, the closed well must remain in operation. Assuming that the Railroad Commission was justified in making such a prediction, it does not follow that the oil under a *closed* well would be depleted as a result of the transfer of its allowable.[8] More-

[8] We think that the use of the "decline curve" can better be explained on the grounds that the Railroad Commission, faced with the problem of curtailing the loss of bottom-hole pressure as a result of some wells producing an excessive amount of salt water, had to devise a basis for determining the amount of the allowable that could be transferred. The use of the "decline curve" was a fair basis for the estimate.

over, there is nothing in the record before us which shows that these closed wells were *in fact* depleted. Nor can we conclude from the evidence before us, that the amount of oil beneath taxpayer's wells was increased as a result of the alleged flow of oil from the tranferors' closed wells.[9] All we know is that the oil which was being extracted came from taxpayer's wells, and since none was produced from the transferors' closed wells, there is a fair presumption that whatever oil was under their lease when the allowable was transferred would still be there when the allowable expired. Even if the transferors' wells did not have as much oil under their leases when the "allowable" expired, there is no evidence in the record which shows that taxpayer's production pursuant to the transferred allowable was the cause of the decease.[10] Therefore, under such circumstances, we cannot conclude that as a matter of physical and geologic reality the transferors had an interest in the oil in place under the taxpayer's wells.

We turn now to the government's second theory in support of its contention that the transferors have the requisite investment in the oil in place. It argues that the

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[9] Admittedly as a result of this conservation measure, which prevented the drop in bottom-hole pressure, taxpayer was able to obtain a greater amount of recoverable oil under its leases. But this does not mean that there was an actual increase of oil under taxpayer's lease.

[10] The government argues that in the event we find that the record before us is insufficient to support the government's contentions, taxpayer nevertheless has failed to meet its burden of proof. We think that the facts before us are sufficient to make a *prima facie* case in favor of taxpayer. It has shown that all the oil which was produced came from its well and none came from the transferors' wells. This raises the presumption that the oil beneath its leases was being depleted. The burden is on the government to prove the contrary. We think that the government has not met this burden.

facts in this case come within the rationale of Southwest Exploration Co., supra, since the assignors of the allowables transferred a property interest which was essential to taxpayer's right to extract the oil in question.

In this area of tax law it is difficult to single out one recurring factor which the courts have found to be indicative of an interest in the minerals in place. The history of economic interest litigation is better described as the story of ascertaining which of several basic characteristics may be omitted without eliminating the possibility of such an interest. A leading authority on depletion,[11] after an exhaustive analysis of the jurisprudence in this area, concluded that

> "[i]n determining the existence of an interest in the minerals in place three basic ideas are involved, viz., the legal form or nature of the instrument, the degree of substantial ownership of the deposit possessed by the interest holder, and the extent and nature of his contribution to development and operation of the property. A legal property interest in the minerals, lasting for the productive life of the property, entitling its holder to significant control of the mineral deposits and beneficial enjoyment of income therefrom, and acquired as the consequence of a contribution to its development or operation, is plainly an interest in the minerals in place. Drop one of these characteristics and the solution of the issue is less certain; drop two and serious doubts arise."

We view our function in this area of tax law as one of weighing these various factors in each case and determining whether their presence or absence are indicative of or preclude the existence of an interest in the minerals in place.

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[11] Sneed, The Economic Interest—An Expanding Concept, 35 Texas L. Rev. 307, 355 (1957).

In so doing, we must recognize that the purpose of discovery depletion should shape the result which we reach. In this respect we must emphasize the fact that Congress sought to encourage the discovery and development of minerals. We recognize also that the Supreme Court decisions reflect a growing liberality in the application of these criteria.[12] However, we do not think it proper for us to take the lead and spearhead this apparent trend. In other words, we should not go beyond the guidelines set forth by the Supreme Court.

In this case the government equates the transferors of the "allowables" with the upland owners in Southwest Exploration who had "made an indispensable contribution of the use of *real property*" to the drilling for and the *extraction* of oil. (350 U.S. at 317, 76 S. Ct. at 400). At the outset it should be noted that aside from Southwest Exploration no Supreme Court decision has found a taxpayer possessing the requisite interest in the mineral in place who did not have either a fee or a leasehold interest in the oil-producing property itself. This apparent departure from prior doctrine can best be explained on the grounds that the granting of discovery depletion in that case served the purposes for which the allowance was created. That is, the upland owners in that case contributed *real property* which was essential to the *discovery, drilling,* and *extraction* of the oil. Without their participation, there would have been no lease,

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[12] This liberal trend can easily be traced commencing with Lynch v. Alworth-Stephens Co., 267 U.S. 364, 45 S. Ct. 274, 69 L. Ed. 660 (1925) and continuing thru Palmer v. Bender, 287 U.S. 551, 53 S. Ct. 225 (1933), Thomas v. Perkins, 301 U.S. 655, 57 S. Ct. 911, 81 L. Ed. 1324 (1937), Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, 66 S. Ct. 861, 90 L. Ed. 1062 (1946) and Commissioner v. Southwest Exploration Co., 350 U.S. 308, 76 S. Ct. 395 (1956). However, the most recent pronouncement in this area, Parsons v. Smith, 359 U.S. 215, 79 S. Ct. 656, 3 L. Ed. 2d 747 (1959) cannot be described as a continuation of this apparent trend.

no wells and no production. In exchange for this contribution, the upland owners acquired an interest which was measured by the producing life of the wells and they could look to the extraction and sale of oil as a source of return for that interest. In other words, "[t]heir income was dependent entirely on production, and the value of their interest decreased with each barrel of oil produced." (350 U.S. at 316, 76 S. Ct. at 400) Not only were they instrumental in the acquisition of the lease, but also they "played a vital role at each successive stage of the proceedings." (Id. at 315, 76 S. Ct. at 399) The Court felt that although the upland owners did not have a legal property interest in the minerals nor did they have control over the mineral deposits, their contribution to development and operation was sufficiently significant to indicate an investment in the oil in place. However, the Court cautioned that they were not taking a drastic step from prior doctrine when they stated:

> "We decide only that where, in the circumstances of this case, a party *essential* to the *drilling* for and *extraction* of oil has made an indispensable contribution of the use of *real property* adjacent to the oil deposits in return for a share in the net profits from the production of oil, that party has an economic interest which entitles him to depletion on the income thus received." [Emphasis added. 350 U.S. at 317, 76 S. Ct. at 400]

In the case at bar, the transferors like the upland owners did not have a legal property interest in the minerals, nor did they have control over the mineral deposits. Thus their entitlement to share in the depletion allowance must be based on their contribution to the development or operation of the mineral deposits. It seems fair to say that their contribution was not as significant a contribution as was made by the upland owners in Southwest Exploration Co.

Their contribution was personal property rather than real property; it was at best indispensable for the extraction of only part of the oil; it was not instrumental in the acquisition of the lease, nor was it essential to the drilling operations. Unlike Southwest Exploration Co., the interest the transferors acquired was not measured by the productive life of the wells but was to be terminated at the expiration of the "allowables." Under these circumstances, to find in the case at bar, an interest in the minerals in place, would require us to go beyond the guidelines set forth by the Supreme Court in Southwest Exploration Co. Moreover, to do so, we think, would do violence to the clear congressional purpose in granting discovery depletion.[13] Consequently, we hold that the transferors of the "allowables" here in question do not have the requisite "economic interest" in the oil in place with respect to the oil produced under these allowables so as to entitle them to share in depletion allowance. Therefore, taxpayer is entitled to take the depletion allowance in question, since the amounts paid by it to these transferors do not constitute royalties and need not be excluded from taxpayer's gross income before computing its depletion allowance for 1952.

Accordingly, judgment is entered for taxpayer with the amount of recovery to be determined pursuant to Rule 47(c)(2) of the Rules of this court.

APPENDIX

11. The following is a typical "Assignment of Shut-in Allowable":

"This agreement, made as of the First day of November, 1951, between ELM OIL COMPANY et al, hereinafter called

[13] This is especially true, if at the expiration of the allowables, the transferors were to reopen the closed wells and resume production. In that event, the transferors would be entitled to depletion twice.

'ASSIGNOR', whose mailing address is P. O. Box 839, Dallas, Texas, and TIDE WATER ASSOCIATED OIL COMPANY, hereinafter called 'ASSIGNEE', with an office in Houston, Texas, WITNESSETH:

"Assignor represents that it has heretofore made application to the Railroad Commission of Texas for the transfer of the oil allowable of the #2 and #3 wells on Assignor's L. L. Jones lease which is a tract of 15 acres, more or less, out of the Corduva Survey of Rusk County, Texas, and is in the East Texas Oil Field; that the application was made pursuant to an order of the Railroad Commission of Texas, herein called 'Commission', of July 10, 1947, No. 6–10,956, Oil and Gas Docket No. 120; that Assignor now owns and operates the oil and gas lease on which the wells to be shut in are located; that the application, in conformity with the procedure established by the commission, bears the approval of the District Supervisor and the District Engineer of the Commission with respect to (a) the right of Assignor to transfer, for production by other wells in said Field, the amount of oil allowable as stated in the approved application, and (b) the transfer to the Assignee, named herein, of the right to produce all of the allowable applicable to the shut-in wells.

"Assignor, for a valuable consideration, hereby sells, transfers and assigns unto Assignee all of Assignor's right to produce the oil in the said Field in the amounts to be approved monthly by the Railroad Commission of Texas. Assignor represents and warrants that Assignor has the right to make this assignment and has not sold or assigned or encumbered in any way the rights herein transferred to Assignee. Assignor further represents and warrants that the lease on which the specified shut-in wells are located is in full force and effect and will be maintained by Assignor in full force and effect during the life of this agreement.

"This assignment shall take effect on the First day of November, 1951. All of the oil produced by Assignee under this agreement shall be the property of Assignee.

"This assignment is subject to the orders of, and the approval of said Commission, the approval and designation by the Commission of the wells and lease from which, and the time at which the allowables, the rights to produce which are herein assigned, may be produced by Assignee, and the designation, by the Commission, in its allowable schedules, of the amount of such allowables which Assignee may produce.

"Subject to the other provisions hereof, Assignee agrees to pay to Assignor a sum of money equivalent to Two Dollars and Four Cents ($2.04) for each and every barrel of such transferred allowable which Assignee produces after November 1, 1951; provided, however, that if at any time hereafter during the life of this contract Tide Water Associated Oil Company has in effect in the East Texas Field an open division order posted price in excess of 2.65 per barrel for the regular oil allowables in said Field, then and in that event, and for each and every barrel of such transferred allowable which Assignee produces during the time such price in excess of $2.65 is posted, Assignee agrees to pay to Assignor a sum of money (in addition to said $2.04) equivalent to 84% of the excess of such posted price per barrel (in effect at the time such transferred allowable is produced) over and above $2.65. It is further provided that if at any time hereafter, during the life of this contract, Tide Water Associated Oil Company has in effect in the East Texas Field an open division order posted price less than $2.65 per barrel for the regular oil allowable in said Field, then and in that event, and for each and every barrel of such transferred allowable which Assignee produces during the time such price less than $2.65 is posted, Assignee agrees to pay to Assignor, in lieu of and instead of the $2.04 per barrel first hereinabove provided for, a sum

of money equivalent to $2.04 less 84% of the difference between such posted price and $2.65. Accounting is to be made on or before the 25th day of each month for the transferred allowable oil produced hereunder during the preceding calendar month.

"Assignor agrees that if Assignee's or Assignor's rights hereunder should come into dispute or litigation Assignee may withhold payment of any sum (to the extent of the amount claimed in such dispute or litigation) payable hereunder, without interest, until final adjudication or other settlement of such dispute or litigation.

"Assignor agrees to make settlement with or payment to all royalty owners and all other parties who have or acquire any interest in the allowable transferred hereunder and agrees to indemnify and save Assignee harmless from any loss, cost, damage or expense suffered or incurred by Assignee by reason of its purchase of or payment for the rights herein conveyed, or by reason of any failure of Assignor to perform any of its obligations arising hereunder.

"In witness whereof, this instrument is executed on the date first above written."

APPENDIX E

Opinion of the United States Court of Claims in *Food Machinery and Chemical Corp.* v. *United States*

FOOD MACHINERY AND CHEMICAL CORPORATION,
a Corporation

v.

THE UNITED STATES

No. 357–59

UNITED STATES COURT OF CLAIMS

July 16, 1965

Before COWEN, *Chief Judge,* LARAMORE, DURFEE and DAVIS, *Judges,* and JONES, *Senior Judge.*

JONES, *Senior Judge.*

The plaintiff, Food Machinery and Chemical Corporation, sues for an alleged overpayment of Federal income taxes for the year 1949 caused by the defendant's disallowance of a deduction to plaintiff for depletion of mineral deposits in that year. The amount claimed by the plaintiff as percentage depletion allowance is $71,778,[1] which, if allowed, will cause a reduction of plaintiff's 1949 income tax in a proportionate amount and a refund will be in order.

The issues presented are (1) did the taxpayer possess the requisite economic interest in the mineral in place, and

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[1] Alternatively, plaintiff claims deductions of $30,911, $7,334, or $5,893, depending on the cutoff point arrived at by the court. (Findings 126-129.)

if it did; (2) what is the proper cutoff point in the processing of the mineral for determining the amount of the depletion deduction to be allowed?

The Facts

The pertinent facts need some elaboration. For over half a century plaintiff has been engaged in the manufacture of phosphate chemicals at its processing plant in Carteret, New Jersey. The basic raw material used by plaintiff is elemental phosphorus which, in 1944, was being produced by electric furnaces at the phosphate mines in Florida and Tennessee. Since these suppliers were also competitors of plaintiff, i.e., they were integrated producer-users, plaintiff was experiencing difficulty in obtaining elemental phosphorus. Plaintiff therefore decided in 1944 to commence production of its own elemental phosphorus and began investigating for deposits of phosphate shale. The deposits lay in Florida and Tennessee, which already were overcrowded, and the Intermountain Western States of Wyoming, Utah, Idaho and Montana. At that time there were no producers of elemental phosphorus outside Florida and Tennessee.

In late 1946 plaintiff was contacted by the Simplot Co. concerning phosphate deposits on the Fort Hall Indian Reservation near Pocatello, Idaho. Simplot was lessee of the mineral rights to this area and had been conducting mining operations since the summer of that year. Two distinct mineral deposits were located there, each in a separate layer in the ground. The lower layer was the more valuable mineral and was termed "phosphate rock." It assayed 30 percent or greater P_2O_5 and was directly usable in Simplot's fertilizer plant at Pocatello. The upper layer, which necessarily had to be extracted in order to mine the

"rock," was termed "phosphate shale." [2] It contained less than 30 percent P_2O_5 and could only be used in the manufacture of fertilizer by first passing it through a very expensive middle process called "beneficiation." The only other feasible use for the shale was to process it in an electric furnace and produce liquid elemental phosphorus. This was also a very costly undertaking.

During the initial phases of mining by Simplot, the rock was transported to its fertilizer plant and the shale was piled on the surface near the mine. After several months of mining operations, it became evident to Simplot that a use for the shale would have to be found in order to make the continued mining of rock economical. Simplot discussed financial arrangements with several companies concerning the construction of an electric furnace but was unsuccessful either in acquiring backing or in inducing someone else to build it. The cost of one furnace was estimated at between $2,500,000 and $3,500,000.

When plaintiff was contacted in late 1946, it sent its own mining engineers to Idaho to investigate the deposits. It was soon evident that several electric furnaces would need to be constructed to make the venture economically feasible, and that a minimum of 25 years' supply of shale would also be necessary to recoup the $10,000,000 to $20,000,000 investment. Simplot's and plaintiff's engineers, working together, determined that sufficient reserves were available in place to guarantee plaintiff sufficient shale input to four furnaces for at least 25 years. Once this was known, formal negotiations commenced between the two companies.

In the fall of 1946 when Simplot realized the need for an electric furnace, it had requested the Secretary of the

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[2] Both the high grade "rock" and the low grade "shale" are included in the general classification of phosphate rock.

Interior to lease additional lands up to 2,500 acres in order to secure the reserves necessary to warrant a multimillion dollar investment. Later, when it was known that plaintiff would be the one constructing the furnaces, the final details of the 25-year Indian leases were completed. Plaintiff played an important but unofficial part in these lease negotiations.[3]

The 1947 Indian leases called for a royalty of 30 cents per ton on the rock and 10 cents per ton on the shale. These were subject to adjustment to market price after 10 years. The lease was terminable if the lessee (Simplot) *or its associates* failed to install an electric furnace on or near the Indian Reservation within 15 years. Although the plaintiff was not named in these leases, it was understood by both the lessor (Indians) and the lessee (Simplot) that plaintiff would be the *associate* installing the furnaces, using the shale and paying the 10 cents per ton royalty to the lessor. At this time there was no other known deposit of shale which could economically be used in plaintiff's proposed furnaces. Therefore, plaintiff's furnaces, once constructed, would be entirely dependent upon the shale from Simplot's leases. Removal of this supply of shale would necessitate scrapping the entire investment by plaintiff.[4]

In November of 1947, 4 months after the Indian leases were completed, plaintiff and Simplot finalized their negotiations in an agreement entitled: "Agreement for purchase and sale of phosphatic shale from the Fort Hall Indian Reservation."[5] This agreement was submitted to

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[3] The taxpayer also leased an additional 2,500 acres, since the maximum Simplot could lease was 2,500 acres. This was to keep competition away. Taxpayer's leased lands have never been used. (Findings 34 and 44.)

[4] Findings 41 and 96.

[5] Finding 49.

and approved by the Assistant Secretary of the Interior. By its terms Simplot was to supply plaintiff all its requirements for shale in its furnaces at Pocatello. Plaintiff was restricted from producing fertilizer and Simplot, similarly, was restricted from selling or using phosphate for other than the production of fertilizers. The price for the shale was one dollar ($1.00) per ton and plaintiff was to pay the royalty directly to the lessor (Indians). Simplot was required to set aside reserves of phosphate to guarantee plaintiff a 25-year supply. These reserves could be increased whenever plaintiff installed more furnaces. If Simplot invaded these reserves in order to mine the rock, it had to store and preserve the shale for future use by plaintiff. These reserves would be released if plaintiff failed to construct its furnaces.

The Agreement between plaintiff and Simplot also allowed for plaintiff to take over the operation of the mine if Simplot either could not supply all of plaintiff's shale requirements, or increased the price, or invaded the reserve in order to sell to others and did not replace with other reserves within 20 days. These operations would be at plaintiff's expense but without any compensation or rental to Simplot. Royalties to the Indians would continue to be paid by plaintiff. Provisions were made to allow Simplot to regain possession of the mine whenever it was able to meet the conditions of the original Agreement. The Agreement was to remain in effect as long as the mining leases ran, and plaintiff had the right to correct any default by Simplot in order to keep the leases running.

During the negotiations between plaintiff and Simplot, plaintiff had offered to buy Simplot's interests in the mine and, alternatively, to form a joint venture. Simplot was unwilling to agree to either of these two approaches. A lease and sublease was impractical because the rock and shale could not be mined by separate parties. Only one mining operation was feasible.

Events have occurred as follows since the signing of the Indian leases and the Agreement between plaintiff and Simplot. By 1959 Simplot had invested over $4,500,000 in its fertlizer plant at Pocatello, and plaintiff had invested almost $21,000,000 in its four electric furnaces and related plant equipment. All of the shale processed in plaintiff's plant has been from the Simplot mine and by 1957 all the shale deposits under Simplot's leases had been reserved for plaintiff. Costs of exploration for reserves have been borne by both parties. No shale has been mined by Simplot and used by anyone other than plaintiff except by the consent of plaintiff. The costs of $1 per ton and the royalty have remained unchanged. In 1949, the year plaintiff commenced furnace operation, Simplot delivered over 180,000 tons of shale to plaintiff. By 1956 the annual supply was over 500,000 tons, with Simplot receiving over $500,000 and the Indians over $50,000 in royalties.

Simplot, by 1959, had spent almost $2,000,000 on the operation of the mine. Other expenses incurred in geological research of the area have been borne jointly. A railroad company was contacted by both plaintiff and Simplot in 1948 and induced to build a spur track at its own expense from the mine to the two plants near Pocatello.[6] The company was to be reimbursed 50 cents for each ton of rock or shale transported. Construction of the spur track was not economically feasible if only the rock were to be transported. Simplot's fertilizer plant used about 36,000 tons of rock each year, whereas plaintiff's four furnaces used about 500,000 tons of shale yearly. By 1954, plaintiff had paid the railroad over $1,000,000 compared to Simplot's $152,000.

If these facts add up to the possession by plaintiff of an "economic interest" in the phosphate shale in place, then a

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[6] Finding 81.

depletion allowance should be granted. Before considering the law on this point, however, one further fact should be noted. In 1957 Simplot and plaintiff entered into a supplemental agreement which superseded the terms of "purchase and sale" contained in the original 1947 Agreement. The effective date of this new Agreement was contingent upon the issuance of a ruling by the Internal Revenue Service that the new contract gave plaintiff a depletable economic interest in the shale. A ruling favorable to the plaintiff was made on October 8, 1957. Until then, plaintiff had not attempted to make deductions for depletion of the shale.

In the new Agreement of 1957 plaintiff was granted a sublease on the shale deposits in return for annual rental payments to Simplot. Simplot was to continue to mine both the rock and shale, but was now termed an "independent contractor," and would receive its mining costs from plaintiff. In essence, while the terms were altered, the substance of the Agreement remained unchanged. However, this does shed some light on the intent of the parties in their 1947 Agreement, and so will be referred to when "economic interest" is discussed.

ECONOMIC INTEREST

Whether a taxpayer is to be allowed a deduction for depletion of mineral deposits is entirely a matter of legislative grace. Parsons v. Smith, 359 U.S. 215, 219, 79 S. Ct. 656, 3 L. Ed. 2d 747 (1959). The Corporation Tax Law of 1909, 36 Stat. 11, failed to provide for such a deduction and the hardship to mine operators resulting therefrom caused the Congress to make provision for a depletion deduction in the Revenue Law of 1913, 38 Stat. 114. United States v. Ludey, 274 U.S. 295, 302-303, 47 S. Ct. 608, 71 L. Ed. 1054 (1927). This deduction has been continued in all Revenue Acts since then. Commissioner of Internal Revenue v.

Southwest Expl. Co., 350 U.S. 308, 312, 76 S. Ct. 395, 100 L. Ed. 347 (1956).

The principle underlying the depletion allowance is the "recognition of the fact that the mineral deposits are wasting assets and [the deduction for the depletion] is intended as compensation to the owner for the part used up in production." Helvering v. Bankline Oil Co., 303 U.S. 362, 366, 58 S. Ct. 616, 618, 82 L. Ed. 897 (1938). This exclusion from gross income "is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired." Commissioner of Internal Revenue v. Southwest Expl. Co., supra, 350 U.S. at 312, 76 S. Ct. at 398. The reasoning behind depletion is thus very similar to that supporting deductions for depreciation in other types of property subject to wear and exhaustion. United States v. Ludey, supra,— 274 U.S. at 303, 47 S. Ct. 608.

Since the depletion deduction was to allow the taxpayer to recover, by the time the mineral was completely exhausted, exactly his investment in the mine, Kirby Petroleum Co. v. Commissioner of Internal Revenue, 326 U.S. 599, 603, 66 S. Ct. 409, 90 L. Ed. 343 (1946), the first few Revenue Acts provided that the depletion allowance was to cease when the total deductions taken over the years added up to a sum equal to the original capital investment. The amount of the depletion deduction for any year was to be "reasonable" and it was left to the Commissioner of Internal Revenue to determine a proper formula. This manner of calculating depletion proved very difficult, and so in the 1926 Act, 44 Stat. 9, a flat allowance of a set percentage of gross income was adopted. Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312, 318, 55 S. Ct. 174, 79 L. Ed. 383 (1934), Kirby Petroleum Co. v. Commissioner of Internal Revenue, supra, 326 U.S. at 603, 66 S. Ct. 409. This fixed manner of calculating depletion deduction has been contin-

ued to the present day, even though the resultant deduction is not equal to nor sometimes even related to the capital investment in the mineral deposit. "[T]he taxpayer is not limited to a recoupment of his original investment [today]. The allowance continues so long as minerals are extracted, and even though no money was actually invested in the deposit." Commissioner of Internal Revenue v. Southwest Expl. Co., supra, 350 U.S. at 312, 76 S. Ct. at 398.

The determination of what parties involved in mining operations are entitled to the depletion deduction has become very difficult. The statute in Section 23(m)[7] calls for an equitable apportionment of the deduction between the lessor and lessee. Whether others can share in the deduction is not stated. In fact, not until the 1918 Revenue Act, 40 Stat. 1057, did the Congress expressly state that a lessor and lessee should share the depletion deduction. Because of this lack of explicitness in the statute, the Supreme Court over the years has found it necessary to apply various fact situations to the statute language. A study of some of these decisions is helpful.

One of the first Supreme Court decisions dealing on this point was Lynch v. Alworth-Stephens Co., 267 U.S. 364, 45 S. Ct. 274, 69 L. Ed. 660 (1925). There, the taxpayer was lessee of iron ore deposits and desired to take depletion deductions on his gross income (the royalties he received from a sublessee) minus the royalties he paid to the lessor-fee owner. The applicable statute at that time, Section 12(a) of the Revenue Act of 1916, 39 Stat. 756, 768, provided for "[a] reasonable allowance for the exhaustion * * * of *property*" [emphasis added], and made no mention of apportionment between lessor and lessee. The

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[7] The applicable statute involved for the tax year in question is the Internal Revenue Code of 1939, Secs. 23(m) and 114, 53 Stat. 1, 14, 45, as amended, Ch. 63, Sec. 124, 58 Stat. 21, 44 (1943), as amended, Ch. 515, Sec. 15, 61 Stat. 917, 919 (1947).

Court construed *property* as meaning a "real and substantial interest [in the mineral deposits]," (at 369, 45 S. Ct. at 275), and not merely legal title therein.

This "broadening" of the relationship of taxpayer-to-mineral-deposit from the possible restricted connotation in the Revenue Acts, was added to in Palmer v. Bender, 287 U.S. 551, 53 S. Ct. 225, 77 L. Ed. 489 (1933). The Court was there concerned with the relationship of a transferor of oil leases who received as consideration for the transfer certain fixed amounts plus a continuing *royalty* of one-eighth of all oil produced. There was no lease here as there had been in Lynch and in Murphy Oil Co. v. Burnet, 287 U.S. 299, 53 S. Ct. 161, 77 L. Ed. 318 (1932); the decision in the latter case holding that both bonus and royalty payments are depletable. The Court in Palmer ruled that the granting or denying of a depletion allowance is not dependent on "the particular legal form of the taxpayer's interest in the property * * *." [287 U.S. at 557, 53 S. Ct. at 226.] Whether the taxpayer leases the property, or assigns it, or transfers it in some other manner, is immaterial. The statute does not confine "depletion allowances to [only] those who are technically lessors." [At 556, 53 S. Ct. at 226.]

> The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil [mineral] in place, and secures, by any form of legal relationship, income derived from the extraction of the oil [mineral], to which he must look for a return of his capital. [At 557, 53 S. Ct. at 226.]

This economic interest [at 557, 53 S. Ct. 225] test developed by the Court in Palmer has been the rule used in all subsequent depletion cases.[8] It has also been adopted by

[8] See Parsons v. Smith, 359 U.S. 215, 221, 79 S. Ct. 656, 3 L. Ed. 2d 747 (1959), for a note on the various opinions since Palmer.

the Commissioner in his Treasury Regulations.[9] This rule boils down to two tests for economic interest: (1) A capital investment in the mineral in place, and (2) a return on the investment which is realized solely from the extraction of the mineral.

Since the Palmer opinion, most decisions ruling for a depletable interest have involved instances where the taxpayer "has once had at least a fee or leasehold in the [property]." Commissioner of Internal Revenue v. Southwest Expl. Co., 350 U.S. 308, 315, 76 S. Ct. 395, 399, 100 L. Ed. 347 (1956). It is fairly obvious that a taxpayer can get in a position where he must look solely to the extraction of the mineral for a return on his investment, and yet not possess a lease or title. But, can the same taxpayer meet the other test requirement of Palmer and the Treasury Regulations if his investment is not in a lease or title to the property?

In Helvering v. Bankline Oil Co., 303 U.S. 362, 58 S. Ct. 616, 82 L. Ed. 897 (1938), the Court ruled that a gasoline processor that receives its natural gas via its own pipelines running from the wellheads, and pays royalties to the well owners, has no economic interest in the gas in place, but merely an economic advantage acquired "through a contractual relation to the owner, * * *." [At 367, 58 S. Ct. at 618.] The taxpayer did not meet either of the two tests; it could not compel production of gas at the well (i.e., no investment in the oil), and was not entirely dependent upon the gas well in question for a return on its investment.[10] Thus, in Bankline, the taxpayer's *lack*

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[9] Treasury Regulations 111, sec. 29.23(m)—1 (1941), as amended, T.D. 6031, 1953-2 Cum. Bull. 120.

[10] In the Tax Court opinion, 33 B.T.A. 910 (1936), it was stated that Bankline would probably have installed its extensive gasoline plant regardless of whether the gas well in question was available or not.

of control over production of the mineral became one of the prime tests for determining whether it possesses an *economic interest in the mineral.*

The next case after Bankline dealing with taxpayers who have never possessed either a fee or leasehold interest in the property, was Commissioner of Internal Revenue v. Southwest Expl. Co., 350 U.S. 308, 76 S. Ct. 395, 100 L. Ed. 347 (1956). This is the leading case in which the Court has found an economic interest to exist under these circumstances. However, in Southwest the facts were very unique and the Court was careful to limit its expansion of the Palmer concept to cover just these unique facts.[11] The State of California required by law that all drilling for offshore oil must be done from filled lands or from upland sites and that permission from the upland owners was necessary to acquire a lease from the State. Southwest Exploration Company obtained a lease from the State to drill from specified upland sites, the upland owners having agreed to this use of their land in consideration of royalties from all future oil production. There were no filled lands available and so, without the consent of the upland owners, there could be "no bid, no lease, no wells and no production." [At 315, 76 S. Ct. at 399.] The State also could cancel the lease if Southwest defaulted in any of the conditions, including those with the upland owners.

The Court termed the upland owners as being "essential parties to any drilling operations." Their "controlling position" over production was the drilling site which

[11] "We decide only that where, in the circumstances of this case, a party essential to the drilling for an extraction of oil has made an indispensable contribution of the use of real property adjacent to the oil deposits in return for a share in the net profits from the production of oil, that party has an economic interest which entitles him to depletion on the income thus received." 350 U.S. 308, 317, 76 S. Ct. 395, 400 (1956).

they could have sold but, instead, kept as their investment in the *oil in place*. They had to look solely to the oil production for a return on their investment and so met both tests of Palmer and the Treasury Regulations. Therefore, Southwest and the upland owners were required to share the depletion allowance.

Since the decision in Southwest, the Court has considered two cases in which the facts were more near those of Bankline than Southwest, and consequently, has ruled *against* a presence of an economic interest in both instances. Both cases involved owners or lessees of coal mines who had contracted with certain independent mine operators to have the operators mine the coal at their own expense and deliver it to the owner or lessee for a fixed sum. In the first of these cases, Parsons v. Smith, 359 U.S. 215, 79 S. Ct. 656, 3 L. Ed. 2d 747 (1959), the contracts "were completely terminable without cause on short notice" [at 224, 79 S. Ct. at 662], and all the investment of the operators was in their equipment which was movable and so not susceptible to scrapping if the mine closed down.

In Paragon Jewel Coal Co. v. Commissioner of Internal Revenue, 380 U.S. 624, 85 S. Ct. 1207, 14 L. Ed. 2d 116 (1965), underground mining instead of strip mining was involved and so the expense to the operators was greater than in Parsons and less of their investment was recoverable on termination. However, all the equipment was movable, all royalties were paid by the lessee, and the coal was delivered to the lessee. The operators had no obligation to continue mining—whether the lessee could terminate as in Parsons was disputed. The lessee also controlled the price paid for the coal delivered. In both cases, the mine operators looked to the owner or lessee for a return on their investment, not to the sale of the coal.

Therefore, in both Parsons and Paragon the taxpayer failed to meet either of the two tests of economic interest.

Although in both instances the operator conceivably had more invested and was taking a greater risk than the owner or lessee,[12] nevertheless the relationship of the operators to the coal in place was not strong enough.

We feel that the facts in the instant case are stronger on the issue of economic interest than even those present in Southwest, and we therefore find that the taxpayer, Food Machinery, has an economic interest in the phosphate shale in place. Our conclusion is based on the following enumerated circumstances which show conclusively that the taxpayer here has met both tests of economic interest—(1) capital investment in the mineral [shale], and (2) return on the investment based solely on the extraction of the shale.

The circumstances are these: (1) The decision of the taxpayer to construct the electric furnaces was the *sine qua non* of the mining of the shale by Simplot. This was as essential an element to the mining process as the agreement of the upland owners in Southwest, and was equally as irreplaceable. In both Parsons and Paragon other operators were available and so they were not essential parties. (2) The taxpayer had reserves in the shale in place for 25 years. It could compel production of this shale and prevent sales of it to anyone else.[13] (3) The lease by

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[12] See the dissent in Paragon by Mr. Justice Goldberg, in which Mr. Justice Black joined.

[13] The trial commissioner's finding 66, which the court adopts, states:

> "The 1948 Simplot agreement was cast in terms of sale by Simplot and purchase by plaintiff of tonnages of furnace grade shale, but the substance of such agreement was that plaintiff thereby acquired reserves of furnace grade shale in place, to be mined and delivered by Simplot to plaintiff at a 'price' covering Simplot's mining costs, thereof, plus a 10 percent profit, with Indian royalties on such shale payable by plaintiff."

Simplot was terminable by the Indians if the taxpayer did not construct the electric furnaces. (4) The price paid by taxpayer to Simplot for the shale was not the market price but rather a fixed amount which covered mining expenses plus a 10 percent profit. (5) The taxpayer had its own geologists participate in studies of the mine and shared in various exploratory expenses. (6) The investment by the taxpayer in the electric furnaces and the payments to the railroad far exceeded the investment by Simplot. (7) The taxpayer was required to look solely to the shale in Simplot's mine for a return on its $20,000,000 investment. There was no other supply of shale economically possible, and these multimillion dollar furnaces would need to be scrapped if the shale in the Simplot mine disappeared. (8) Simplot's investment in the mine was dependent upon the taxpayer's continued use of the shale. (9) The taxpayer paid royalties on the shale directly to the lessors and not via the lessee Simplot.

Can it be thought for a moment that any reasonable business man would invest $20,000,000 in four huge immovable electric furnaces at a site completely isolated from all sources of raw input except one, and not first secure an ironclad guarantee to that lone raw input! We feel that this compromises a requisite capital investment in the mineral and is in line with the economic interest rule as laid down in Palmer and all the cases thereafter.[14]

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[14] This holding is not in conflict with our recent decision in Tidewater Oil Co. v. United States, Ct. Cl., 339 F.2d 633, decided December 11, 1964. Determinations on tax depletion are made "according to the peculiar conditions in each case * * *." Section 23(m), Internal Revenue Code 1939. "[I]t is impossible to escape nice distinctions in the application of complicated tax legislation." Mr. Justice Frankfurter's separate opinion in Burton-Sutton Oil Co. v. Commissioner of Internal Revenue, 328 U.S. 25, 38, 66 S. Ct. 861, 868, 90 L. Ed. 1062 (1946). The lack of an economic interest in Tidewater was based on several facts which are distinguishable from the instant case: (1) The assignor received none of the oil produced.

The change in the agreement between Simplot and the taxpayer in 1957, and the favorable ruling by the Commissioner on depletable interest which the taxpayer acquired therefrom, we feel are insignificant in reaching our conclusion for the 1949 tax year. Whether the taxpayer thought it had a depletable interest prior to 1957, and whether the 1957 agreement significantly altered the essentials of the 1947 agreement (we feel it did not), cannot be given much weight. It does bear on the intent of the parties but, we feel, in this case the intent *at the time* (1949) is conclusively made apparent from the facts present then.

DEPLETION CUTOFF POINT

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[Original Opinion Continues with Discussion of an Issue Not Pertinent Herein.]

Accordingly, judgment is entered for plaintiff with the amount of recovery to be determined pursuant to Rule 47(c)(2) of the Rules of this court.

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(2) The investment of the assignors was not necessarily depleted when the transferred allowables were produced. (3) The contribution of the assignor was not essential to continued production, nor to the acquisition of the lease. (4) The interest of the assignor was not measured by the productive life of the oil well. (5) And most important, the assignor did not possess a $20,000,000 investment that was essential to the oil production and that depended for its very existence on the oil in place.

APPENDIX F

Opinion of the United States Court of Claims in *Union Bag-Camp Paper Corp.* v. *United States*

UNION BAG-CAMP PAPER CORPORATION v.
THE UNITED STATES.

U. S. Court of Claims, Nos. 147-64—150-64, 10/14/66.

Before COWEN, Chief Judge, LARAMORE, DURFEE, DAVIS and COLLINS, JUDGES.

On Plaintiff's Motion and Defendant's Cross Motion for Partial Summary Judgment

COWEN, Chief Judge, delivered the opinion of the court: Plaintiff deducted as ordinary and necessary business expenses (1) annual payments made by it under various leases for the exclusive use of timberlands, and (2) a portion of its expenses in managing these wooded tracts. The Internal Revenue Service disallowed the deductions, treating the yearly rentals as capital expenditures forming a part of the acquisition cost of timber and the management expenses as amounts allocable to the cost of timber sales.

Suing for the refund of taxes alleged to have been unlawfully assessed and collected, plaintiff invokes the principle of collateral estoppel and has moved for partial summary judgment on the basis of an earlier decision of this court involving the same parties. Except for the tax years in question, the facts of the instant case parallel those of our 1963 decision in *Union Bag-Camp Paper Corp.* v. *United States*, 163 Ct. Cl. 525, 325 F.2d 730, where we held that the annual payments in dispute constituted ordinary and necessary business expenses under section 23(a)(1)(A) of the 1939 Code.[1]

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[1] Section 162(a) of the 1954 Code. Of the 23 leases in issue, only 10 were involved in the prior litigation. Plaintiff's motion is therefore confined to those 10 leases.

For a more detailed presentation of the facts, see our earlier opinion, especially the findings of fact beginning in 163 Ct. Cl. 550 (1963).

Since 1916, the plaintiff has been engaged in the manufacture of paper, paper bags, and related products. During the past 30 years, it has owned or leased timberlands for the purpose of supplying its manufacturing process with continuous crops of pulpwood.[2] In conjunction with this program, the plaintiff adopted extensive scientific methods for the management, conservation, and enhancement of the timber growth on such lands. Rather than depleting the forest by annual and excessive removal of timber, its "tree farming" technique has achieved a cyclical and recurring crop of timber for current and future use.[3]

Under most of the leases, the plaintiff agreed to refrain from cutting during the first 7 years in possession. Thereafter, removal of the trees was restricted to the annual growth of pulpwood-size timber.[4] Resultingly, the realty will be returned to the lessors with as much timber as existed thereon when the leases were executed.[5]

Plaintiff's timber rights were complemented by the acquisition, with minor exceptions, of the complete and exclusive use and control of the leased lands, including "all timber, logging, wood, turpentine and naval stores, oil, mining, mineral, water, water power, grazing, farming and

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[2] For example, in 1949, plaintiff purchased approximately 85% of its pulpwood requirements from others and cut only about 15% from property it owned or leased.

[3] At the time of the prior litigation, plaintiff had a Woodlands Division comprised of nearly 425 employees, of whom 90 were graduate foresters.

[4] Payments to the lessors for the cutting of timber which exceeded the annual growth were reported by the plaintiff as the purchase price of the timber, and are not involved in this litigation.

[5] Compare the following definition: "[D]epletion is based upon the concept of the exhaustion of a natural resource . . ." Mertens, Law of Federal Income Taxation, Vol. 4, § 24.02.

hunting rights . . .''[6] In return the plaintiff was obligated to pay the lessor ''as rental'' an annual sum equivalent to 5 percent of an agreed and specified value of the leased lands. It also consented to satisfy all taxes levied upon the properties and to deposit annual amounts (5 to 10 cents per acre) into a forestry fund for fire protection and overall management of the timberlands.

It is our opinion that both the law and the facts compel adherence to the conclusion reached by us in 1963—namely, that the plaintiff became a party to a true lease and that its payments thereunder are deductible as ordinary and necessary business expenses. As noted in our earlier decision:

> Whatever words are used to describe the transaction in question, the inescapable fact remains that plaintiff's annual payments are made to acquire the exclusive use, possession, and enjoyment of the leased lands, including as a part of those possessory rights, the right to cultivate and cut the annual timber growth. . . . Looking at the forest instead of the trees, the only ultimate change contemplated for these timberlands is one of improvement to the timber stand, not depletion thereof.
>
> It follows that . . . [the] payments required to be made by plaintiff should be deemed to constitute ''rentals or other payments required to be made as a

[6] Plaintiff was also entitled to build and maintain roads, wells, mines, and other structures on the land. The rights thus acquired were not financially inconsequential. In 1949, plaintiff realized income of $40,354.62 from miscellaneous uses of the properties (oil and mineral rentals, easements, turpentine leases, etc.). These factors further help to demonstrate that plaintiff did not, as contended by defendant, just purchase standing timber.

> condition to the . . . use or possession . . . of property" and should therefore be deductible from gross income in their entirety under section 23(a)(1)(A) of the 1939 Code [section 162(a) of the 1954 Code].[7]

The defendant challenges plaintiff's reliance on collateral estoppel by arguing that two recent decisions coming from the Fifth Circuit and the Supreme Court have effected a change or development in the controlling legal principles sufficient enough to lift the bar of collateral estoppel. With the defendant's contention as to the application of these two cases, *Dyal* v. *United States*, 342 F.2d 248 (5th Cir. 1965) and *United States* v. *Catto* 384 U.S. 102 (1966), we must express our disagreement.

In *Dyal*, our plaintiff's lessors sought capital gain treatment of the amounts received under the agreements now in issue. Attempting to negative the view that the sums were rentals which conferred exclusive use and enjoyment of the possessory rights attaching to the timberlands, they set forth the theory that a sale of the timber had been consummated between Union Bag and themselves. In opposition to this, the Government relied on our holding in the 1963 *Union Bag* case. While unwilling to grant blanket capital gain treatment, the Fifth Circuit held that the lessors could be afforded this tax advantage to the extent of the fair market value of the timber "*actually in existence* at the execution of the contracts." To this extent, *Dyal* is in disagreement with some of the reasoning in our 1963 decision, although not necessarily with our result.[8]

The Fifth Circuit justified its allocation formula in *Dyal* by reference to two revenue rulings issued in 1962. *Rev. Rul.* 62-81, 1962-1 *Cum. Bull.* 153; *Rev. Rul.* 63-82, 1962-1

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[7] 163 Ct. Cl. 525, 541-42, 325 F.2d 730, 739 (1963).

[8] See 342 F.2d 248, 254, footnote 13.

Cum. Bull. 155. Admittedly, the contracts construed in these rulings contemplated, as here, the utilization of accepted forestry practices and the return of the leased properties with as much timber as was standing at the inception of the agreements. Each of them, however, contained factors which not only lend support to the conclusion reached in the rulings that a present sale of existing timber had occurred but which also render our facts readily distinguishable.

Whereas the contract payments in *Revenue Ruling* 62-81 were computed according to a fixed rate per cord, those involved here depend upon a specified value of the leased lands.[9] By the very terms of the contract in the ruling, the owner agreed to "sell" and the paper company to "buy" all the timber growing or to be grown on the tract.

The controlling factor, however, relates to the rights realized by the parties under their respective leases. Here, Union Bag acquired rights tantamount to the exclusive use and control of the timberlands, including mineral and mining rights, farming and hunting privileges, the right to sublease, to build and operate roads, and to grant easements. Of significance, too, is the fact that several portions of the property were devoid of trees at the time the leases were negotiated and that the plaintiff could not exercise its cutting rights for the first 7 years of each rental period.

Moreover, there is no indication that the lessees involved in the revenue rulings became vested with a legal interest as extensive as that gained by Union Bag. To the contrary, the landowner in *Revenue Ruling* 62-82 retained all mineral rights and further agreed to reimburse the paper company for areas used by the landowner in its sand and gravel operations and for any damage to the timber resulting from such activities. And in *Revenue Ruling* 62-81, the rights which here form an integral part of the plaintiff's agreement are relegated to a residuary status: "Pay-

[9] In *Rev. Rul.* 62-82, there was a lump sum payment.

ments under the contract not attributable to timber existing at the execution of the contract are not proceeds of sale of timber by the landowner but are consideration for the use of the land by the paper company . . ."[10]

The distinction is this: Rights essential to the timber itself and the exchange thereof were of pivotal importance in both rulings; whereas, here, there is an agreement focusing upon the land and creating rights and obligations evidencing a lease in the true sense of the word. For these reasons, we stand by our earlier decision and disagree with the Fifth Circuit's sweeping application of *Revenue Rulings* 62-81 and 62-82.[11]

Lastly, the defendant urges that *United States v. Catto* 384 U.S. 102, 103 (1966), has sufficiently altered the relevant legal principles to preclude an application of collateral estoppel. In that case, the Supreme Court was called upon to decide:

> [W]hether taxpayers engaged in the livestock business who use an accrual method of accounting for

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[10] 1962-1 *Cum. Bull.* 153, 155.

[11] The Fifth Circuit felt that its decision was not incompatible with our 1963 holding that the payments by the lessee were deductible from gross income. Its conclusion in this respect was predicated upon § 1.631-2(e) of the Regulations which states that amounts paid by a lessee "*for timber or the acquisition of timber cutting rights,* whether designated as such or as rental . . . shall be treated as the cost of timber and constitute part of the lessee's depletable basis of the timber, irrespective of the treatment accorded such payments in the hands of the lessor." (Emphasis added.) Utilization of this regulation, however, begs the question since it presupposes the rendition of payments for "timber or the acquisition of timber cutting rights." While this may have been the situation in the revenue rulings, it is our conclusion that the agreements here involved were more extensive and such as to render allocation logically unnecessary and realistically impractical.

> animals raised for sale may employ a cash method of accounting for animals raised for breeding purposes, in order to take advantage of a federal income tax benefit available to cash-method taxpayers when breeding animals are sold.

Answering this question in the negative, the Court held that the Commissioner had acted within the permissible scope of his discretion in denying the taxpayers' request to adopt the more advantageous method of accounting. A reading of *Catto* convinces us that its facts and legal problems are so alien to those before us that the decision can be summarily dismissed as inapplicable.

There being no significant change in the legal climate the doctrine of collateral estoppel is dispositive of the present litigation. Plaintiff's motion for partial summary judgment is therefore granted with respect to the leases involved in the prior litigation, and defendant's cross motion is denied. The case is returned to the trial commissioner for further proceedings, including a determination of the amount of refund due pursuant to Rule 47(c)(2).

CONCURRING OPINION

DAVIS, *Judge*, concurring: I am unwilling to apply the bar of collateral estoppel, but instead would adhere on the merits to our ruling in 163 Ct. Cl. 525, 325 F.2d 730 (1963). There are two reasons, in my view, why it is inappropriate to invoke collateral estoppel. The first is the subsequent decision of the Fifth Circuit in *Dyal v. United States*, 342 F.2d 248 (1965), involving the same lease-agreements and the same lands; that coordinate holding, sharply diverging in rationale from our 1963 decision, seems to me to have clouded the legal sky over this particular tax sector noticeably enough to dissolve estoppel. See *CBN Corp. v. United States* No. 263-62, decided July 15, 1966; *Hercules Powder*

Co. v. United States 167 Ct. Cl. 639, 647, 337 F.2d 643, 647 (1964) (dissenting opinion).[1] The second reason for not applying collateral estoppel is that many of the facts here, although parallel to those in the 1963 case, are separate from and not identical with the earlier circumstances. *Commissioner v. Sunnen* 333 U.S. 591, 601 (1948), tells us that in such a case the doctrine is not to be used. See *Hercules Powder Co. v. United States, supra.* For these reasons I would openly reach and dispose of the merits.

On that phase I agree with the court, since I am not persuaded that we erred in 1963. The Chief Judge's opinion points out that, in substance as well as in form, these were true *leases* of land, not merely sales or dispositions of timber. The taxpayer had the usual rights of leaseholders and actually enjoyed those privileges. See, *e.g.*, footnote 6 of the court's opinion. Defendant does not deny that if these were indeed leases of land, rather than sales or conveyances of timber, the taxpayer would be entitled to deduct the amounts paid in effect as rent for the land. The major expenditures here fell into that category and, accordingly, were chargeable as ordinary and necessary expenses of the business. As the court says, the *Dyal* opinion should not be followed insofar as it suggests that these agreeements were timber sales and not leases; the revenue rulings on which the Fifth Circuit relies are distinguishable, dealing as they do with other forms of agreement.[2]

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[1] As for *United States* v. *Catto*, 384 U.S. 102 (1966), the livestock breeding decision. I agree with the court that it has no bearing upon either aspect of the present case.

[2] On the deduction of the management expenses, the Government argues only that *Catto* implicitly disapproved our 1963 holding, but surely *Catto* cannot be stretched that far. See footnote 1, *supra.*

APPENDIX G

Excerpts from the Findings of Fact and Opinion of the Tax Court of the United States in *Shamrock Oil and Gas Co.* v. *Commissioner*, 35 T.C. 979

* * *

FINDINGS OF FACT

Some of the facts have been stipulated and are hereby found as stipulated.

The Shamrock Oil and Gas Corporation, hereinafter referred to as Shamrock, was incorporated in 1929 and during all of the period here involved, i.e., from December 1, 1942, through November 30, 1954, kept its books on a fiscal year basis on an accrual basis of accounting. The taxable years involved are the fiscal years ending November 30 of 1943, 1944, 1945, 1946, 1947, 1948, 1949, 1950, 1951, 1952, 1953 and 1954.

Shamrock filed corporation income and declared value excess-profits tax returns and corporate excess-profits tax returns for the fiscal years 1943 to 1946, inclusive, and corporate income tax returns for the fiscal years 1947 to 1954, inclusive, with the district director of internal revenue or his predecessor at Dallas, Texas.

Shamrock is an independent oil company with integrated operations for the production and processing of oil and gas and for the distribution and sale of oil and gas products to pipelines, industrial users, carbon black companies, and to Shamrock's dealers in eight States.

All of the natural gas, with respect to which there is any controversy regarding what was the "gross income from the property" for the purpose of computing percentage depletion, was produced by Shamrock and was processed in Shamrock's gasoline extraction plants.

Shamrock's principal operations for the production of natural gas have been in the West Panhandle gasfield of Texas and in the Texas-Hugoton gasfield.

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The Panhandle and Hugoton Gasfields

The Panhandle gasfield starts in the eastern part of Wheeler County and extends northwestward across portions of Collingsworth, Gray, Hutchinson, Potter, Carson, and Moore Counties, Texas, into Dallam County, Texas, where it connects with the Texas portion of the Hugoton field. There is no physical separation between the fields designated as the East Panhandle field, the West Panhandle field, the Texas Hugoton, Oklahoma Hugoton, or Kansas Hugoton fields. The "East Panhandle" and the "West Panhandle" fields and the area designated "Texas Hugoton field" are all located in the State of Texas.

The East Panhandle and West Panhandle fields are both a part of the same common reservoir and are separated by the Railroad Commission of Texas for administration purposes rather than because of physical differences.

Gas was first discovered in the Panhandle of Texas in a well started in 1918 and completed in 1919 at a point approximately 20 miles north of Amarillo, Texas. Gas was first discovered in the Kansas portion of the Hugoton field in 1922 at about the same time it was discovered in what is now the Olkahoma Hugoton field. Exploration began to find production in the Texas Hugoton field as early as 1940, but it was not thought that the fields were connected until about 1946 when sufficient wells had been drilled to definitely establish the connection between them.

The Oklahoma Hugoton and Kansas Hugoton fields are located in those respective States.

The Panhandle field, consisting of both the East and West Panhandle fields, contains approximately 1,500,000 acres and is approximately 120 miles in length in an eastward and westward direction, and varies in width from 10 to approximately 50 miles. The Hugoton field extending from point of connection with Panhandle field to the northern limits of the Kansas Hugoton field, is approximately 160

miles. The total distance from the top of the Kansas Hugoton field down through the Panhandle field to its eastern tip is approximately 280 miles. Before it was known that the Panhandle field and the Hugoton field were connected, the Panhandle gasfield was known as the largest gas-producing area in the world. The Hugoton field covers approximately 900,000 acres in Oklahoma, 2,400,000 acres in Kansas, and about 640,000 acres in Texas. This, with approximately 1,500,000 to 1,600,000 acres in the Panhandle field, brings the entire reservoir, i.e., Panhandle and Hugoton fields, to approximately 5,500,000 acres.

The East Panhandle field, the West Panhandle field, and the Texas portion of the Hugoton field, as well as Kansas, Oklahoma, and Texas portion of the Hugoton field are all in one reservoir which is uninterrupted and connected all the way.

The reservoir pressure in the Panhandle gasfield at the beginning was approximately 430 pounds per square inch. As gas has been produced through the years there have been declines in reservoir pressure from the original reservoir or rock pressure. The virgin pressure of 430 pounds per square inch was not the average pressure during the taxable years here involved. At the beginning of the taxable period the weighted average pressure in the sour gas area was approximately 350 pounds. The normal decline or withdrawals in the sour gas area has been from 10 to 12 pounds a year.

At the beginning of the taxable period the pressure in the Texas Hugoton field was very close to the virgin pressure of 430 pounds per square inch. At that time the average pressure in the sour gas portion of the field was approximately 100 pounds less than that of 430 pounds per square inch. As gas has been produced since that time pressure has become lower in proportion to the withdrawals.

Petitioner first made an investment in compression equipment in fiscal year 1948. The purpose of the compression equipment was to maintain pressures in the lines

and plants at about a 200-pound level. In later years, further investment was made by petitioner for the construction of additional compression plants.

Little development occurred in the Panhandle field at first because the initial well had about one-third of the normal rock pressure for the depth from which gas was produced, and it was thought to be a freak well. Additionally, the area was not heavily populated. The rapid development of the field did not start until the Borger, Texas, boom in about 1925 with the development of an oilfield which is along the north portion or rim of the Panhandle field.

The Texas Hugoton field, in general, produces what is known as sweet gas while the Panhandle field produces both sweet and sour gas. Sour and sweet gas are both produced from the same reservoir in the Panhandle field.

In the West Panhandle field, the sour gas supply is higher in heating value than the sweet gas. This is not a result of the gas containing sulphur. The richer gas is normally found closer to the oil production and the sour gas adjoins the oil-producing area of the Texas Panhandle.

A royalty interest is a right to oil and gas in place that entitles its owner to a specified fraction, in kind or in value, of the total production from the property, free of expense of development and operation. In Texas, customarily, a royalty owner receives one-eighth of the value of the gas.

The working interest is an interest in oil and gas in place that is burdened with the cost of development and operation of the property.

An overriding royalty is similar to a royalty in that each is a right to oil and gas in place that entitles its owner to a specified fraction of production, in kind or in value, and neither is burdened with the costs of development or operation. They differ in that an overriding royalty is created from the working interest, and its term is coexten-

sive with that of the working interest from which it was created.

Raw gas is the gas as it comes from the well. Raw gas as it emerges from the wellhead is in a gaseous state. It is a colorless gas and essentially is a mixture of gases in equilibrium. The mixture of gas consists principally of hydrocarbons in a gaseous form.

Residue gas is that portion of the raw gas which remains after the extraction of the liquefiable hydrocarbons which are present in the raw gas. The residue is that portion which is marketed as a gas after the liquefiable hydrocarbons are extracted. Raw natural gas in the Panhandle is composed of the residue elements and the liquefiable hydrocarbons.

All raw natural gas contains some liquefiable hydrocarbons in suspension. The liquefiable hydrocarbons that are generally extracted in the Panhandle field are propane, isobutane, normal butane, isopentane, normal pentane, and the remaining heaviest portion, generally called hexane-plus.

Natural gasoline includes all of these hydrocarbons in their liquid state. In the industry it is customary to apply the term natural gasoline to that portion of these liquids used by refineries in blending motor fuels. Isopentane, normal pentane, and hexanes are the same as natural gasoline. Motor fuel is motor gasoline, a finished gasoline.

In the Panhandle field, methane is the principal constituent of the natural gas and constitutes approximately 80 percent of the total volume of the raw gas. If all of the liquefiable hydrocarbons from propane or heavier hydrocarbons were removed from the Panhandle gas, approximately 95 percent of the volume of the original raw gas would remain.

Residue gas is made up principally of methane, but it also includes ethane and some inert elements such as carbon dioxide, nitrogen, and helium.

Gas, raw or residue, may be either sour gas or sweet gas. Sour gas is natural gas having more than 1½ grains

of hydrogen sulphide per 100 cubic feet, or more than 30 grains of total sulphur per 100 cubic feet. Sweet gas is all natural gas except sour and casinghead gas. Casinghead gas is any gas and/or vapor indigenous to any oil stratum and produced from such stratum with oil. Casinghead gas is gas produced with oil and comes out of solution with the oil.

Natural gas includes sweet gas, sour gas, and casinghead gas taken from the earth through gas wells, oil wells, or distillate wells.

Sour gas, before removal of the hydrogen sulphide, is not desirable for light and fuel purposes because, in burning, it produces a poisonous gas, is corrosive, and has a bad rotten-egg odor.

The heating value of sweet and sour gas is comparable. The raw sweet gas in the West Panhandle field has a B.t.u. content of approximately 1,060 B.t.u.'s per cubic foot. Raw sour gas has a B.t.u. content of approximately 1,070 B.t.u.'s per cubic foot. The raw sweet gas in the Hugoton field portion of the Texas Panhandle has a lower heating value and ranges a little below 1,000 B.t.u.'s per cubic foot because of a higher nitrogen content.

B.t.u., or British thermal unit, is a standard of measurement for determining the heating value of gas.

The terms "dry gas" and "wet gas" are relative terms. Dry gas generally means gas produced from a well which does not produce oil. Cashinghead gas, sometimes called wet gas, is produced from a well which does produce oil. Wet gas contains a higher percentage of liquefiable hydrocarbons. In the oil and gas industry, the term "wet gas" is applied generally to gas having a high content of liquefiable hydrocarbons.

"LPG," or liquefied petroleum gas, consists usually of a mixture of propane and butane and is used as a gas for domestic and some industrial purposes where natural gas is not available.

* * *

Disposition of Gas

Prior to 1933, the owner of a sour gas well had no outlet for his gas because dry gas was not permitted to be used for any purpose other than light and fuel purposes and sour gas was not suitable for pipeline purposes. At that time, sour gas wells were shut in as a general rule. Casinghead gas, however, could be burned to make carbon black.

Prior to 1941, interstate pipeline operators did not consider sour gas as a source of supply to them. They objected to sour gas because the hydrogen sulphide in the gas had a corrosive effect on the steel pipeline and on burners and its burning produced dangerous, incomplete combustion with an objectionable rotten-egg odor.

The act of the Texas legislature commonly called "the stripping law" was passed in 1933 and under this legislation it became legal to process gas to extract the liquefiable hydrocarbons and to waste the residue gas by simply venting it into the air. The volume of vented gas reached the point where it exceeded a billion cubic feet of gas per day in the Panhandle of Texas.

The conservation statutes of Texas were revised in 1935 and, in addition to other modifications, the stripping law was repealed and the "popping" of gas into the air was prohibited.

In May 1935 a new law known as House Bill No. 266 was adopted. Under this law, sour residue gas could be burned in the manufacture of carbon black, provided the liquefiable hydrocarbons were first extracted, and provided that the carbon black plant averaged a production yield of at least one pound of carbon black per thousand cubic feet of gas consumed. The statute also limited the amount that could be burned for this purpose to a total of 750 million feet of gas per day and limited the privilege of burning it to gas from common reservoirs in the State of Texas, containing both sweet and sour gas, and 200,000 acres or more in

extent. The effect of these limitations was to make the law applicable only to the Panhandle field. Sweet gas could only be burned, under the statute, for carbon black manufacture if the sweet gas was casinghead gas that was produced with oil. It was not permissible to use sweet gas for any purpose other than light and fuel under House Bill No. 266 unless the sweet gas might be produced in the form of casinghead gas with oil.

In approximately 1947, an amendment was adopted which permitted the burning of sweet gas in furnace-type carbon plants, as differentiated from channel-type plants, provided the purchaser of the gas paid a price equal to the average price, which was to be determined by the Railroad Commission of Texas, being paid for sweet gas in the field during the month in which the gas was taken.

From 1943 through 1954, approximately 75 or 80 percent of the raw natural gas in the West Panhandle and Texas-Hugoton gasfields was owned by producers who processed their own gas. This left only 20 or 25 percent of the gross production of raw natural gas in the West Panhandle and Texas-Hugoton gasfields available for sale.

During the years 1943 through 1954, most of the gas was owned by the producer and was processed by the producer so that he either sold or used residue gas and liquefied hydrocarbons. The interstate pipelines in most instances processed gas produced by them.

In making contracts for the sale of raw gas or residue gas the length of the contract is a factor bearing on the contract and the price to be paid for the gas. As a general rule, purchasers are desirous of obtaining a long-term supply.

It is customary to negotiate sales of gas on relatively long-term bases. Where raw gas is sold, the investment involved in connecting the gas is great. Purchasers of raw gas must build expensive facilities to collect and

process the raw gas and, therefore, such purchasers require long-term contracts. Where residue gas is sold to an interstate pipeline, a long-term contract is required for regulatory purposes. An interstate pipeline is often in the market for residue gas so that it can increase its market outlet. To do so it has to file application for such expansion program with the Federal Power Commission and adequate reserves is one of the factors considered by that Commission in passing on the application.

Interstate pipelines cannot get permission under the interstate pipeline regulations to construct pipelines and other facilities unless they can show a sufficient supply of gas to justify the investment. Shamrock entered into long-term contracts for the sale of residue gas because that was the only way it could sell gas to the purchaser who, in turn, had to build his facility and pipelines. Thus, Shamrock sold gas on long-term bases because that was the only way that it could sell it.

In the West Panhandle and Texas-Hugoton gasfields from 1943 through 1954, all sales of raw gas were under long-term contracts. Most of these long-term contacts had escalator clauses increasing the price on gas periodically according to the terms of the contract.

At all times here material and during the period from December 1, 1942, through November 30, 1954, Shamrock owned and operated a gasoline extraction plant known as its McKee Gasoline Plant located on Section 399, Block 44 H&TC Ry. Co. Survey, Moore County, Texas, and from July 15, 1947, through November 30, 1954, Shamrock owned and operated a gasoline extraction plant, known as its Sunray Gasoline Plant, located on Section 170, Block 3–T, T&NO Ry. Co. Survey, Moore County, Texas, approximately 3 miles east of the McKee Plant. In each of these gasoline extraction plants, various liquefiable hydrocarbons were extracted (through an absorption process) from gas in

which an economic interest was owned by Shamrock and which gas was produced from properties owned in whole or in part by Shamrock. Shamrock additionally processed in such plants during such periods additional volumes of gas in which it did not own an economic interest. The gas with respect to which a controversy as to depletion exists is only that volume of gas in which Shamrock owned an economic interest and which gas was processed in one of the above-named Shamrock Plants (i.e., McKee or Sunray).

Shamrock constructed its first gasoline extraction plant in 1933. The Sunray plant was originally constructed by the Magnolia Petroleum Company which gathered its own gas, processed it, and sold the residue gas to a carbon black plant in the area of the processing plant. Shamrock purchased the Sunray Plant from the Magnolia Petroleum Company in 1947.

An extraction plant is designed to extract the liquefiable hydrocarbons from natural gas. It is a usual matter that raw gas is brought by a gathering system to a central point in the Panhandle area and in the Texas portion of the Hugoton area for processing. This is true because of the economics of handling and delivering gas. It is not feasible or practical to construct an extraction plant for each well.

Shamrock's gas-gathering system connects the individual wells and leases and brings the gas to a central point where it is processed for the extraction of the natural gas liquids and after the gas has been brought to the extraction plant and the liquids extracted, the residue gas is then delivered into the lines of the purchaser of that residue gas.

The terrain in Moore and Sherman Counties where Shamrock gas production is carried on is generally level, smooth terrain with practically no trees. There is no subsoil rock that would interfere with the laying of gather-

ing lines for the production of gas. It is an ideal country for laying pipelines.

In Shamrock's collection lines or gathering lines sweet gas and sour gas are mixed. It is more economical to put the entire stream through the Girbitol plant than it would be to gather and process the gas separately.

After the gas is brought to the McKee and Sunray Plants, the liquefiable hydrocarbons are extracted from the gas. The residue gas remaining is sold to the pipeline companies or to other customers or utilized by Shamrock as plant fuel, etc. The liquefiable hydrocarbons, now in a liquid form, are either sold to customers or utilized by Shamrock in its refinery.

Shamrock has not made sizable sales of raw gas. Since it has had its processing plants and gathering system, it has sold only residue gas with slight exception. With respect to sales of raw gas, Shamrock made no sales during the period 1943 through 1954 at the wellhead as such as distinguished from out of its gathering system. If there were any wellhead sales they were of no consequence.

In the beginning of the taxable years in question, Shamrock sold most of its sweet gas as raw gas but processed its sour gas. However, in 1944 Shamrock sold most of its sweet gas producing wells and leases to Phillips Petroleum Company. After 1944 Shamrock made no similar sales of raw sweet gas. When Shamrock sold sour gas residue under its first residue gas pipeline contract to Panhandle Eastern Pipeline Company in 1945, it included the sale of residue gas from the sweet gas leases that were dedicated under that contract.

When the gas enters the gasoline extraction plant for processing, it goes first to the absorber which is a vessel in which the gas flows against the absorption oil. This absorber or tower at the McKee Plant is about 20 to 30 feet tall and from 5 to 7 feet in diameter. The gas goes in at the bottom of the tower and out at the top. Only

line pressure is used for running the gas through the tower either without compression or after compression, as the case may be. No heat is applied at this stage. As the gas moves up the tower oil is pumped against the flow of the stream of gas, and the oil absorbs liquefiable hydrocarbons out of the raw gas stream. The natural gas not absorbed in the oil is called residue gas.

* * *

The residue gas comes off the absorber in the initial stage. It is largely methane (approximately 80 percent of the volume of the residue) and it includes some ethane, propane, and occasionally some butane, and certain inert materials such as helium, carbon dioxide, and nitrogen. After the liquefiable hydrocarbons are removed from the raw gas, there remains approximately 95 percent of the volume of the original raw gas.

* * *

From 1943 to 1954, inclusive, Shamrock made sales of residue gas to carbon black companies. From 1933 to 1943, most of the sour gas residue was sold to carbon black companies.

A channel-type carbon black plant operates on the basis of insufficient combustion of gas with the flame impinging upon a metal surface or channels to cause the accumulation of soot or carbon which is removed by periodically scraping that carbon black off the metal surface and collecting it. The carbon produced by the channel-type plant is in the form of fine carbon particles and is suitable for combination with natural rubber to make commercial rubber products. The carbon produced by the furnace-type method produced larger particles and this gray-type black is more effective for combination with synthetic rubber to make rubber products.

Under the sour gas law passed in 1935, the extraction of gasoline was required before the sour gas residue could

be used for the manufacture of carbon black. With the passage of this sour gas law in 1935, it was necessary that Shamrock find an outlet for its residue gas. It found an outlet through the carbon black industry by inducing carbon black companies either to construct or move plants to an area adjacent to Shamrock's natural gasoline extraction plant.

Shamrock joined with Continental Oil Company in forming Continental Carbon Company in which Shamrock owned a 30 percent interest. Continental Oil Company likewise furnished a part of the capital for Continental Carbon Company.

Shamrock on October 15, 1936, agreed to purchase all of the raw gas from approximately 10,000 to 12,000 acres of leases from Continental Oil Company. The purchase of the Continental Oil Company gas was a special arrangement in connection with the formation and construction of the Continental Carbon Black Plant in partnership with the Continental Oil Company.

In addition to the Continental Carbon Company, Shamrock assisted Reliance Carbon Company financially in establishing its plant near Shamrock's McKee Plant. This assistance took the form of permitting a deduction in the price paid to Shamrock for gas sold to the carbon company until the accumulated deductions equaled the cost of moving the plant from Louisiana and reconstructing it in the Panhandle of Texas.

There were five carbon black plants constructed in the vicinity of Shamrock's McKee Plant. Shamrock committed to each of these carbon black companies the furnishing of a definite volume of gas for the life of the field. This was necessary in order for Shamrock to induce these carbon black companies to provide the market for Shamrock's residue gas. The companies that built plants in the area and with whom Shamrock had contracts were Continental Carbon Company, Crown Carbon Company, Reliance Car-

bon Company, later known as United Carbon Company, and Columbian Carbon Company. To induce these carbon black companies to provide a market for the residue sour gas by locating near the McKee gasoline extraction plant, Shamrock dedicated residue gas from certain acreages for the life of the leases to the carbon black companies. All contracts made with these companies had such long-term dedications.

In September 1937, the Crown Carbon Company built a plant 0.2 of a mile from the McKee Plant and Crown purchased residue gas from Shamrock from 1943 to March 1954.

In June 1936, the Columbian Carbon Company built a plant 1.28 miles from the McKee Plant and Columbian purchased residue gas from Shamrock from 1943 to August 1953, inclusive.

In January 1937, Continental Carbon Company built a plant 2.46 miles from the McKee Plant and Continental Carbon purchased residue gas from Shamrock from 1943 to 1954, inclusive.

In June 1936, Reliance Carbon Company built a plant 0.014 of a mile from the McKee Plant and Reliance purchased residue gas from Shamrock from 1943 to January 1953.

In September 1937, Shell-Columbian Carbon Company built a plant 0.091 of a mile from the McKee Plant and Shell-Columbian purchased residue gas from Shamrock from 1943 to December 1951.

The price basis on which Shamrock sold the residue gas to the carbon black companies for supplying their requirements was 30 percent of the carbon black yield, less certain deductions such as sales and packaging and warehouse expenses, etc., to give a net price to Shamrock in the neighborhood of 25 percent to 26 percent of the value of the carbon black produced from the gas.

Each of the contracts with these carbon black companies provided that, in the event the purchaser elected to discontinue the manufacture of carbon black, then it had the right of resale and the contract set forth the percentage basis upon which the revenue from such resale would be divided between the carbon company and Shamrock even though the carbon company should elect to move its plant from the area.

The economics of the gas industry early in the taxable period changed to where all of the gas that had been sold to the carbon black companies was resold to pipeline companies. Shamrock participated in the resale of that gas and in the revenue received. Additionally, Shamrock handled, with the consent or permission of the carbon black companies, the negotiations of the contracts which were made disposing of the gas to the various pipeline companies. The first contract for the resale of this gas was made in 1947. Shamrock continued to make these contracts of resale of gas until all of the gas was sold.

At the time of the resale of this gas the value of the gas for light and fuel purposes exceeded the value of the gas for carbon black manufacture.

The delivery of gas to Continental Carbon Company started with the completion of the Continental Carbon Company's channel-type carbon black plant in 1937 and continued until the residue gas was sold to pipeline companies in increments beginning with the sale to Texoma Natural Gas Company. The date of the first sale to Texoma Natural Gas Company was July 1, 1947.

Shamrock continued to produce gas, extract gasoline, and sell the majority of residue gas for carbon black manufacture up to the beginning of the period here involved in 1943.

Shamrock negotiated new contracts with the carbon black companies prior to a resale of the gas to pipeline companies. In the renegotiations the prices for the gas were put on a flat basis of a certain sum per MCF and

the amount that was being paid for carbon black was substantially increased. In these contract negotiations the minimum price to be paid to Shamrock in the event of a resale was likewise increased. In the original contracts, it was provided that in the event a carbon black company ceased using gas and made a resale of the gas Shamrock would receive the first 2 cents per thousand cubic feet and the balance would be divided on a 50-50 basis between the two companies. In these renegotiated contracts for sale of gas to carbon black companies, it was provided that the first 3 cents would be received by Shamrock and the balance would be divided 50-50.

* * *

APPENDIX H

Opinion of the United States Court of Appeals for the Seventh Circuit in *Lynch* v. *Commissioner*

JOE LYNCH,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

No. 11083.

UNITED STATES COURT OF APPEALS

SEVENTH CIRCUIT.

Nov. 4, 1954.

Before DUFFY, Chief Judge, and MAJOR and LINDLEY, Circuit Judges.

MAJOR, Circuit Judge.

The Commissioner of Internal Revenue (respondent) determined deficiencies in the income tax of petitioner, Joe Lynch (sometimes referred to as the taxpayer), for the years 1944 and 1945, in the amounts of $24,821.01 and $23,839.04, respectively. Upon the taxpayer's petition, the Tax Court of the United States, on September 29, 1953, rendered its decision upholding the deficiencies thus determined. The controversy is here upon taxpayer's petition to review and set aside the decision of the Tax Court.

The case involves the validity for tax purposes of a family partnership. For reasons subsequently disclosed, only a brief outline of the facts is required for the purpose of our decision. In 1937, and for several years previous thereto, the taxpayer was engaged as a retail merchant in

men's clothes in the city of Milwaukee, Wisconsin. At that time he had a family consisting of his wife, three daughters, Marjorie, age 26, Helenjane, age 20, and Ruth, age 18, and a son, Joe, age 12. Marjorie and Helenjane were both married in 1940, and Ruth in 1942. For the most part, the daughters since their marriage have lived at places other than in the city of Milwaukee. In 1937, the net worth of petitioner's business was about $44,000. The net income from the business during that and previous years averaged from $4,000 to $6,000. In 1937, petitioner conceived the idea of dividing his estate with his children and for that purpose consulted with Mr. Carl B. Rix, an attorney. (We mention the name of the attorney because of his high standing as a lawyer and splendid reputation for integrity, professionally and otherwise.) Mr. Rix suggested to the taxpayer numerous ways in which the purpose could be achieved, including the formation of a partnership. As a result, a partnership agreement was prepared by Mr. Rix and signed by taxpayer and his three daughters on July 1, 1937. The agreement provided:

> "1. The parties hereto have agreed to become copartners in business for the purpose of engaging in the sale of men's clothing, furnishings and hats in the City of Milwaukee under the firm name and style of Joe Lynch. The partnership shall begin as of July 1st, 1937, and shall continue for a period of fifteen years.
>
> "2. To that purpose Joe Lynch has agreed to transfer, sell and convey to the partnership all his right, title and interest in and to the present business and the assets thereof, including the good-will and trade name thereof, now carried on by him on No. 230-W. Wisconsin Avenue, Milwaukee, subject to the assumption by the partnership of all liabilities of

> said business. The interest of the various parties in and to such partnership is as follows: Joe Lynch, one-fourth thereof; Marjorie Lynch, one-fourth; Helenjane Lynch, one-fourth; Ruth Lynch, one-fourth. The statement of the business now conducted by Joe Lynch as of July 1st, 1937, shall be the basis for the opening of the books of the partnership."

The agreement made provision in considerable detail for the conduct of the partnership business, the manner in which the books were to be kept, a distribution of one-fourth of the profits to each of the partners, and for numerous other matters common and incidental to a partnership business. Petitioner filed a Federal gift tax return for the year 1937 in which he reported gifts of one-fourth interest in the Joe Lynch business to each of his three daughters, and each of the daughters has for that and each succeeding year reported and paid income tax upon the profits of the business distributed to her.

Petitioner before the Tax Court relied upon the doctrine of collateral estoppel as a bar to the instant proceeding, which issue was decided adversely to petitioner. Thereupon, the Tax Court proceeded to hear evidence, make findings and decide the case on what is referred to as the merits, that is, that there was no valid partnership for tax purposes during the years 1944 and 1945, those for which deficiencies have been determined in the instant proceeding.

The taxpayer in his petition before the Tax Court alleged:

> "The identical partnership and the identical issue was before the United States Board of Tax Appeals in the case of Joe Lynch, decided April 17, 1941, Docket No. 102149, reported in the 1941 Memorandum decisions published by Prentice-Hall in Paragraph 41,227. The Board of Tax Appeals' decision that the

Joe Lynch partnership in question was valid, and that only one-fourth of the partnership's net income could be allocated to petitioner in accordance with the partnership agreement, constituted a finding of fact by the United States Board of Tax Appeals."

The Commissioner, as respondent, in answer to this allegation stated:

"Admits that the business of the alleged Joe Lynch partnership is and always has been the ownership, conduct and operation of a retail men's clothing store located in the City of Milwaukee, Wisconsin. Admits that the same partnership agreement and the same issue as to the year 1937 was before the Board of Tax Appeals in the case of Joe Lynch, Docket No. 102149, Memorandum Opinion April 17, 1941, but avers that the facts pertaining to the years 1944 and 1945 were not the same as 1937. Denies that the Board of Tax Appeals' decision as to the year 1937 that the Joe Lynch partnership was valid, and that only one-fourth of the partnership's net income could be allocated to petitioner in accordance with the partnership agreement, constitutes a finding of fact by the United States Board of Tax Appeals controlling as to the years 1944 and 1945."

On January 19, 1940, the Commissioner determined that the entire income of the Joe Lynch partnership business for the period from July 1 to December 31, 1937 was includible in taxpayer's income for the reason that the purported partnership was not recognizable for Federal income tax purposes. On taxpayer's petition, the Board of Tax Appeals, on April 17, 1941, entered its decision in favor of the taxpayer and adverse to the Commissioner. This decision was not appealed by the Commissioner and, therefore, became final.

In its 1941 decision, the Board stated:

> "In the instant case no bad faith has been charged nor shown to have existed in connection with the organization of the partnership. The purpose and intention of the parties, as shown by the record, establishes that the agreement of July 1, 1937, was in fact a bona fide agreement between petitioner and his three daughters, whereby he was to give to each of them an interest in his business and the assets thereof; the four of them as co-partners were to carry on the men's clothing business for profit; the four of them were to have equal capital interests in the business at the start thereof on July 1, 1937; and, also, the four of them were to have equal distributive shares of the net profits derived from that business.
>
> "The petitioner had the right to give each of his daughters an interest in his business and the partnership agreement was not rendered invalid because of the designation of petitioner as the manager thereafter having sole executive control of the business or because of the restriction of the rights of several of the partners to dispose of their capital interest in the partnership, except to petitioner and his son. Commissioner [of Internal Revenue] v. Olds [6 Cir.], 60 F.2d 252 (11 A. F. T. R. 741). The partnership agreement, the setting up of the capital accounts of each of the four partners on July 1, 1937, and the subsequent entries of debits and credits on their respective accounts on the partnership books sufficiently evidenced petitioner's completed gift of cash to his three daughters and their ownership of a one-fourth interest in the clothing business and property from which the income here in question was produced. The partnership agreement was executed by the parties thereto and a valid partnership

between petitioner and his three daughters was formed on July 1, 1937. [Citing cases.]"

The instant proceeding was heard by Judge C. P. Lemire, a Judge of the Tax Court, and on June 4, 1953, the division of that court to which the case had been assigned filed a memorandum opinion, in which it was stated:

> "In this proceeding, although the taxable years are 1944 and 1945, the issue relating to taxation of the income of the 'Joe Lynch' business for those years involves the same gifts, the same partnership agreement, the same partnership, and the same parties as were involved in Docket No. 102149, Joe Lynch, supra. * * *
>
> "Upon consideration of all of the evidence and circumstances we find that the parties had a real intention, in entering into the agreement of July 1, 1937, to join together as partners in carrying on the 'Joe Lynch' business. The respondent's determination is reversed."

On June 12, 1953, the Chief Judge of the Tax Court entered an order withdrawing the findings of fact and opinion lastly referred to. On September 23, 1953, findings of fact were made and an opinion rendered by the Tax Court, in which all of its members participated. Upon such findings and opinion, the decision now under review was predicated. After a detailed review of the facts and the law, the Tax Court concluded that "petitioner and his daughters did not in good faith and acting with a business purpose join or intend to join together in the conduct of the Joe Lynch business enterprise," and "that no valid partnership existed in the years 1944 and 1945 between petitioner and his three daughters and that the entire net income from such business in those years is taxable to petitioner."

The court in its opinion conceded that it had previously held "that the agreement involved herein constituted a valid partnership between petitioner and his three daughters." It held, however, that *res judicata* or collateral estoppel was without application because the Supreme Court (decisions subsequently referred to) has "altered the legal concept of the facts essential for the determination of what constitutes a valid family partnership and has necessitated a broadening of the scope of inquiry in ascertaining whether or not such facts exist in a given case."

Five members of the Tax Court dissented, three of whom joined Judge LeMire (the Judge who tried the case) in an opinion sustaining the taxpayer's contention on the issue of *res judicata* or collateral estoppel. In such dissenting opinion, among other things it was stated:

> "The identical issue of the validity of the partnership was before the Board of Tax Appeals in the proceeding of Joe Lynch, Docket No. 102149 (memorandum opinion, April 17, 1941), with respect to the year 1937, the first year of the agreement's operation. There has been no change in the controlling facts since that time. * * *
>
> "We determined in the prior proceeding that there was a valid gift by the petitioner of capital interests in the business to his daughters and that the parties in good faith intended to carry on the business as equal partners. Since, under the rule of the Sunnen case [Commissioner of Internal Revenue v. Sunnen, 333 U.S. 591, 68 S. Ct. 715, 92 L. Ed. 898] we are not at liberty to reopen our inquiry as to those facts, the ultimate question of the validity of the partnership is likewise foreclosed. We should therefore sustain the petitioner on the *res judicata* issue."

Notwithstanding the Commissioner's assertion in answer to taxpayer's petition "that the facts pertaining to the years 1944 and 1945 were not the same as 1937," there is no showing of any change in the factual situation material to the issue as to whether the partnership was valid for tax purposes. As pointed out by the dissenting members of the Tax Court, "There has been no change in the controlling facts since that time [1941 decision]." Nor do we understand that either the Tax Court's decision or the Commissioner's argument before this court is predicated upon a changed factual situation but that the decision and argument rest squarely upon what is asserted to be a change in the law. In any event, the instant proceeding involved the same parties, the same partnership agreement and a business operated in the same manner as it was in the beginning. In fact, the witnesses in the instant proceeding were the same as those in the 1941 proceeding, including petitioner's attorney, Mr. Rix. In this connection, it is interesting to note that petitioner in the instant proceeding offered to introduce in evidence a transcript of the former proceeding which, on objection of the Commissioner, was refused. The fact that the transcript of the former proceeding was available and denied admission on objection by the Commissioner dispels any thought or claim that might otherwise exist that there was any material difference in the evidentiary facts of the two proceedings.

That the Commissioner is hard pressed in the instant proceeding is shown by a statement made at the beginning of the hearing. Referring to the partnership agreement, he stated, "The sole motive is apparently to save income tax. I think the evidence will show that that was the sole motive." There is not a scintilla of evidence in support of the assertion that income tax was a motivating factor in the formation of the partnership. No such purpose was found by the Tax Court and neither is it relied upon by the Commissioner before this court. The Tax Court did

state, "His attorney told him that his purpose could be accomplished through the formation of a partnership and advised petitioner that a partnership would reduce income tax." The latter part of this statement perhaps is literally true but, even so, it is calculated to mislead. The purpose of the partnership in its relation to income tax is of such importance as to justify quoting the testimony of Mr. Rix on that point. He stated, "Naturally I discussed —I considered it myself and I discussed it with Mr. Lynch in forming my opinion as to what was the best plan which he did put up to me, best solution of what he desired. I think any attorney would have been derelict if he hadn't considered taxes. But we were in the depression and the taxes were not high and if you ask me now as to whether or not it was an important element I would say no, because it was no factor to make me consider the question of taxes as an important element in the situation that then existed."

Thus, we have a situation where the Board in 1941 expressly found and decided (see opinion previously quoted), (1) no bad faith was charged or shown to have existed in connection with the organization of the partnership; (2) purpose and intent of the parties was bona fide; (3) petitioner made a completed gift to each of his three daughters of a one-fourth interest in his business and the assets thereof; (4) they as co-partners were to carry on the men's clothing business for profit; (5) the four of them acquired a capital interest in the business on July 1, 1937, and each was to have an equal distributive share of the net profits derived therefrom; (6) the interest thus acquired by the daughters produced the income sought to be taxed to petitioner, and (7) a valid partnership among petitioner and his three daughters was formed on July 1, 1937.

While it is not expressly mentioned it must be implicit in the findings made by the Board and the conclusion

reached that the partnership was not formed either to avoid or to evade taxes. In any event, as already noted, there is no finding in the instant proceeding that such was the case, nothing more than a hint that such might have been a motivating factor.

The Commissioner in his brief poses the contested issue thus: "Whether the Tax Court was correct in holding that, because of the change in the legal concept of the facts essential for the determination of what constitutes a valid family partnership since its prior judgment involving the same alleged partnership for the year 1937, the principle of *res judicata* or collateral estoppel did not apply to the instant proceeding." Stripped of its illusive verbiage, this issue, so we think, is reduced to the simple question as to whether the law as to what constitutes a valid partnership for tax purposes has been changed in the interim between the Board's former decision and that of the Tax Court in the instant case.

The issue presents only a question of law, which we conclude was decided erroneously by the Tax Court. The evidentiary facts are precisely the same in each of the two proceedings. It is for this reason that we think it unnecessary to relate in detail the inferences, ultimate findings and conclusions drawn by the Tax Court in the instant proceeding from the evidentiary facts. Any difference in the appraisement of the evidentiary circumstances results from the fact that such circumstances were appraised by one set of eyes in 1941, and by another in 1953. Such difference is not, in our judgment, attributable to a change in the law. The facts as found and issues adjudicated in 1941 are those which must be accepted in deciding whether petitioner is now entitled to the benefit of the legal doctrine of collateral estoppel.

Collateral estoppel is a refined version of the doctrine of *res judicata*. Both its purpose and application have been much discussed. In Commissioner of Internal Rev-

enue v. Sunnen, 333 U.S. 591, 68 S. Ct. 715, 92 L. Ed. 898, the court defines the meaning to be attributed to *res judicata* and collateral estoppel. As to the latter doctrine, the court stated, 333 U.S. at page 598, 68 S. Ct. at page 719:

> "But matters which were actually litigated and determined in the first proceeding cannot later be relitigated. Once a party has fought out a matter in litigation with the other party, he cannot later renew that duel. In this sense, *res judicata* is usually and more accurately referred to as estoppel by judgment, or collateral estoppel. * * * But if the later proceeding is concerned with a similar or unlike claim relating to a different tax year, the prior judgment acts as a collateral estoppel only as to those matters in the second proceeding which were actually presented and determined in the first suit. Collateral estoppel operates, in other words, to relieve the government and the taxpayer of 'redundant litigation of the identical question of the statute's application to the taxpayer's status.' Tait v. Western Md. R. Co., 289 U.S. 620, 624, 53 S. Ct. 706, 707, 77 L. Ed. 1405.

In the cited Tait case, the court, 289 U.S. at page 624, 53 S. Ct. at page 707, stated:

> "The public policy upon which the rule [*res judicata*] is founded has been said to apply with equal force to the sovereign's demand and the claims of private citizens. Alteration of the law in this respect is a matter for the law-making body rather than the courts. [Citing case.] It cannot be supposed that Congress was oblivious of the scope of the doctrine, and in the absence of a clear declaration of such purpose, we will not infer from the annual nature of the exaction an intent to abolish the rule in this class of cases."

Notwithstanding this pronouncement in the Tait case, the court in Sunnen stated, 333 U.S. at page 600, 68 S. Ct. at page 720, that the "legal atmosphere" might be so altered between the two proceedings as to make the doctrine of estoppel inapplicable. Even so, however, the court stated, 333 U.S. at page 601, 68 S. Ct. at page 721:

> "Of course, where a question of fact, essential to the judgment is actually litigated and determined in the first tax proceeding, the parties are bound by that determination in a subsequent proceeding even though the cause of action is different."

In United States v. Munsingwear, Inc., 340 U.S. 36, 38, 71 S. Ct. 104, 106, 95 L. Ed. 36, the court quoted with approval from Southern Pacific R. Co. v. United States, 168 U.S. 1, 48-49, 18 S. Ct. 18, 42 L. Ed. 355, as follows:

> "' * * * even if the second suit is for a different cause of action, the right, question or fact once so determined must, as between the same parties or their privies, be taken as conclusively established, so long as the judgment in the first suit remains unmodified.' "

In the still later case of Partmar Corp. v. Paramount Pictures Theatres Corp., 347 U.S. 89, 90-91, 74 S. Ct. 414, 416, the court stated:

> "But a prior judgment between parties has been held to operate as an estoppel in a suit on a cause of action different from that forming the basis for the originally suit 'only as to those matters in issue or points controverted, upon the determination of which the finding or verdict was rendered.' This latter aspect of *res judicata* is the doctrine of collateral estoppel by judgment, established as a procedure

for carrying out the public policy of avoiding repetitious litigation."

The meaning of the phrase, "legal atmosphere," mentioned in Sunnen has not been amplified or explained in any subsequent court decision of which we are aware, although in Dr. Salsbury's Laboratories v. I. D. Russell Co. Laboratories, 8 Cir., 212 F.2d 414, 416, the court cited the Sunnen case for the proposition that a new cause of action was stated only "if there has been a decisive change in the law".

In any event, we come to the question as to whether there has been such a change in the law (or "legal atmosphere") either by statute or Supreme Court decision which makes the doctrine of estoppel inapplicable to the instant situation. Neither the Tax Court in its opinion nor the Commissioner in his brief in this court points out in what respects the law relating to a valid partnership has been changed. Rather, they deal in generalities. The Tax Court in its opinion states:

> "The decisions in the Supreme Court cases cited [referring to Commissioner of Internal Revenue v. Tower, 327 U.S. 280, 66 S. Ct. 532, 90 L. Ed. 670; Lusthaus v. Commissioner, 327 U.S. 293, 66 S. Ct. 539, 90 L. Ed. 679, and Commissioner of Internal Revenue v. Culbertson, 337 U.S. 733, 90 S. Ct. 1210, 93 L. Ed. 1659] have altered the legal concept of the facts essential for the determination of what constitutes a valid family partnership and has necessitated a broadening of the scope of inquiry in ascertaining whether or not such facts exist in a given case. This change in the law or the concept of the law has to a large extent rendered obsolete the legal concept upon which the Olds case [Commissioner of Internal Revenue v. Olds, 6 Cir., 60

F. 2d 252] was decided and upon which our decision in Docket No. 102149, supra, was based."

It will be noted that there is no assertion that there has been a change of the law as to what constitutes a valid partnership for tax purposes but only that there has been a change in the appraisement to be placed upon the facts, which means, so we think, nothing more than that the Supreme Court has admonished that greater vigilance be applied in determining whether a family partnership is bona fide, that is, for a business purpose, in contrast to a purpose to avoid taxes. In our view, the law as to what constitutes a valid partnership for tax purposes, family or otherwise, has not changed. The present test is no different from that announced in the Olds case, upon which the Board in its former opinion relied. Good faith on the part of the parties and the intention that a partnership be formed are set forth in the Olds case as the cardinal principles, citing London Assurance Corp. v. Drennen, 116 U.S. 461, 6 S. Ct. 442, 29 L. Ed. 688. In the Culbertson case, supra, the Supreme Court announced the test thus, 337 U.S. at page 742, 69 S. Ct. at page 1214:

> "The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard * * * but whether, considering all the facts * * * the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. There is nothing new or particularly difficult about such a test. Triers of fact are constantly called upon to determine the intent with which a person acted."

In a footnote to the last quotation, the court stated, 337 U.S. at page 743, 69 S. Ct. at page 1215:

> "State of mind has always been determinative of the question whether a partnership has been formed as between the parties",

citing Drennen v. London Assurance Corp., 113 U.S. 51, 56, 5 S. Ct. 341, 28 L. Ed. 919, the same case cited and relied upon by the court in the Olds case. The Drennen case was twice before the Supreme Court, which accounts for the fact that it is cited in one instance as 113 U.S. 51, 5 S. Ct. 341, 28 L. Ed. 919, and in the other as 116 U.S. 461, 6 S. Ct. 442, 29 L. Ed. 688.

Even in the Tower case so greatly relied upon, the court stated, 327 U.S. at page 286, 66 S. Ct. at page 535:

> "When the existence of an alleged partnership arrangement is challenged by outsiders, the question arises whether the partners really and truly intended to join together for the purpose of carrying on business and sharing in the profits or losses or both. And their intention in this respect is a question of fact, to be determined from testimony disclosed by their 'agreement, considered as a whole, and by their conduct in execution of its provisions.' "

Drennen v. London Assurance Corp., 113 U.S. 51, 56, 5 S. Ct. 341, 28 L. Ed. 919, is cited in support of this rule, and immediately after the citation, the court in Tower states:

> "We see no reason why this general rule should not apply in tax cases where the government challenges the existence of a partnership for tax purposes."

This statement from Tower is reiterated by the Supreme Court in Culbertson, 337 U.S. at page 742, 69 S. Ct. at page 1214.

We disagree with the reasoning of the Tax Court that the test to be employed in determining the validity of a partnership as announced in the Olds case, upon which the previous decision of the Board was predicated, has been changed; in fact, it was expressly stated, as already noted, in the Culbertson case, "There is nothing new or particularly difficult about such a test." In this connection, the concurring opinion of Mr. Justice Frankfurter in the Culbertson case is of interest as well as important. In discussing the previous Tower decision, he stated, 337 U.S. at page 754, 69 S. Ct. at page 1220:

> "We should leave no doubt in the minds of the Tax Court, of the Courts of Appeals, of the Treasury and of the bar that the essential holding of the Tower case is that there is 'no reason' why the 'general rule' by which the existence of a partnership is determined 'should not apply in tax cases where the Government challenges the existence of a partnership for tax purposes.'"

No good purpose could be served in stating or discussing certain of the language contained in Tower and Lusthaus upon which the Commissioner relies as showing that the "legal atmosphere" with reference to family partnerships has been changed. If such was the case, it appears that such atmosphere was restored to normalcy by the Supreme Court in Culbertson. Moreover, a reading of numerous opinions by Courts of Appeals leads to the view that Tower and Lusthaus engendered more confusion than light. See Miller v. Commissioner, 6 Cir., 183 F.2d 246; Ginsburg v. Arnold, 185 F.2d 913, 916; Ardolina v. Commissioner, 3 Cir., 186 F.2d 176; Britt's Estate v. Commissioner, 5 Cir., 190 F.2d 946, 951; Alexander v. Commissioner, 5 Cir., 194 F.2d 921, 924; Seabrook v. Commissioner, 5 Cir., 196 F.2d 322, 326.

Marcus v. Commisisoner, 5 Cir., 201 F.2d 850, an opinion by Chief Judge Hutcheson, voices some forthright criticism of the Commissioner for his failure to recognize the limitations which Culbertson places upon Tower and Lusthaus. The court, evidently referring to the member of the Tax Court who had decided the case, stated, 201 F.2d at page 852:

> "It was, therefore, inevitable that, in her approach to the decision of the case, it was not the voice of Culbertson which guided her but the dead hand of Tower and Lusthaus, as commissioner and tax court, even after Culbertson, had persisted in misinterpreting and misapplying them."

Other Court of Appeals, particularly the Second Circuit, have appraised Culbertson differently than the Commissioner would have us do. In Levin v. Commissioner, 199 F.2d 692, 694, the court stated:

> "But the Culbertson case does not require active participation to make a person a partner for tax purposes. On the contrary, it made it clear that no one element is essential. The Supreme Court decided against the taxpayer because the only evidence of an intent to form a partnership was the expectation that the taxpayer's sons would, in the future, contribute their time and services to the partnership. That decision was reached not because an indispensable element was lacking, but because the one element present was not enough to justify a finding of intent to carry on a present partnership."

Again, the same court in Dyer v. Commissioner, 2 Cir., 211 F.2d 500, 503, stated:

> "This court, after so reading [Culbertson], said, in Slifka v. Commissioner of Internal Revenue, 2 Cir.,

182 F.2d 345, 346, that the test in cases such as this is 'whether an association, or joint venture, which satisfies all formal requirements and may be valid as between the parties, has been created to promote the conduct of their business in any other way than by reducing taxes. That this makes motive a test of tax liability is true enough; but it is equally true that it makes it so only when the reduction of taxes is the sole motive. That does not mean that "business" may not be so conducted as best to keep down taxes; but it does mean that keeping down taxes is not of itself "business".'"

On the issue of collateral estoppel, we are not concerned with whether the Board in its 1941 decision found the facts correctly or incorrectly. The point is that the facts have not changed and that the findings as made at that time are binding and conclusive on the parties in a subsequent proceeding. The same is true of the law as applied to the facts in the previous proceeding unless in the meantime the law has changed, which we think it has not. In our view, the Tax Court should have sustained the taxpayer's position on the issue of collateral estoppel and as a consequence should have eliminated the deficiencies asserted by the Commissioner.

For the reasons thus stated, the decision of the Tax Court is

Reversed.